

Investment Management Arrangements and the Federal Securities Laws

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Professional investment managers are responsible for the investment of an ever-increasing part of the nation's wealth. Mutual funds manage trillions of dollars of other people's money, while banks, insurance companies, pension plans, investment advisers, broker-dealers, other institutions, and individuals manage much more.¹ The federal securities laws are an important element of the legal regime governing investment management.² Investment managers trigger federal securities laws when they offer or sell securities, and thus the whole effect of these laws turns on what the word "security" means. An investment manager who invests a client's funds in stocks or bonds is subject to the federal securities laws. However, an investment management arrangement may itself be a security. If it is, the federal securities laws attach as soon as the investment manager offers to serve a prospective client even if the managed funds will not be invested in statutory securities.

This Article explores the regulation of investment management arrangements as securities. Part I briefly surveys the federal securities laws that govern the offer and sale of securities by investment managers. Part I then discusses the unusual circumstances of the early 1970s that led courts and the Security and Exchange Commission ("SEC") to insist on a broad definition of the word "security," which, it turns out, encompasses a wide variety of investment management arrangements. Although the circumstances that led to this expansion of the scope of the federal securities laws no longer apply, the

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This article, in a modified form, will comprise part of the authors' forthcoming treatise on the law of investment management.

¹ See Martin J. Gruber, *Another Puzzle: The Growth in Actively Managed Mutual Funds*, 51 J. FIN. 783, 784-85 (1996); see also Robert Charles Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 561, 564 (1981) ("The increasing separation of the decision about how to invest from the decision to supply capital for investment is one of the most striking institutional developments in our century."); Jane E. Willis, *Banks and Mutual Funds: A Functional Approach to Reform*, 1995 COLUM. BUS. L. REV. 221, 221-23.

² See *infra* Part I.A.

law established in response to them still determines whether investment management arrangements are securities. This law, created largely to fill gaps in a dated regulatory regime, now poses substantial risks for investment managers and threatens to distort the regulation of investment management.

Part II examines the law governing whether investment management arrangements are securities, focusing on the requirement of common enterprise, the relevance of the way control is allocated between manager and investor, and the special status of trust arrangements. Part III deals with the related question of whether collections of managed accounts are investment companies. Part IV examines the principles and policies at play when investment management arrangements are subjected to regulation under the federal securities laws. Although courts called upon to judge investment management arrangements do not always clearly articulate the principles that guide their decisions, identification of these principles is essential for policymakers charged with administering and perfecting the federal securities laws and for managers and investors trying to structure their affairs to comply with them. This Article concludes that the question of whether an investment management arrangement is a security should turn on the degree to which the manager is responsive to the individual situation and objectives of the owner of the managed assets.

I. APPLICATION OF THE SECURITIES LAWS TO INVESTMENT MANAGEMENT ARRANGEMENTS

A. *Securities Laws Governing Investment Management Arrangements*

The federal securities laws regulate the activities of investment managers through three mechanisms: (1) the registration requirements of the Securities Act of 1933 ("Securities Act"),³ the Securities Exchange Act of 1934 ("Exchange Act"),⁴ and the Investment Company Act of 1940 ("Investment Company Act"),⁵ which require the filing of extensive documentation with the SEC and effectively force managers to disclose information to investors; (2) the regulatory regimes of the Exchange Act, the Investment Company Act and the Investment Advisers Act of 1940,⁶ which regulate the business practices of investment managers; and (3) the broad proscriptions of fraudulent activity contained in the several federal statutes.⁷

³ 15 U.S.C. §§ 77a-77z (1994).

⁴ 15 U.S.C. §§ 78a-78ll (1994).

⁵ 15 U.S.C. §§ 80a-1 to -64 (1994).

⁶ 15 U.S.C. §§ 80b-1 to -18a (1994).

⁷ See 15 U.S.C. §§ 77q(a), 78j(b), 78o(c)(1) (1994), 17 C.F.R. § 240.10b-5 (1995).

The Securities Act requires that, absent an exemption, an issuer of securities must file a registration statement with the SEC before its securities may be offered for sale and forbids securities to be sold until the registration statement becomes effective.⁸ Once a registration statement has been filed, the form and content of prospectuses are closely regulated,⁹ and, broadly speaking, written offers of securities are prospectuses.¹⁰ The Investment Company Act, again speaking broadly, forbids an investment company to offer or sell its securities unless the company is registered under that Act.¹¹ The operative term "offer" is so broadly defined in both acts that it includes most promotional activities of investment managers.¹² Thus, if an investment management arrangement is a security, the registration requirements of the Securities Act and the Investment Company Act may both require the investment manager to make extensive filings with the SEC before commencing operations and may regulate the form and substance of the process by which the investment manager subsequently offers its services.¹³

The disclosure regime of registration is supplemented by substantive

Management activities after funds are invested may also be subject to regulation. *See* 15 U.S.C. § 80b-6 (1994) (prohibiting transactions by investment advisers).

⁸ *See* Securities Act § 5(a), (c), 15 U.S.C. § 77e(a), (c) (1994).

⁹ *See* Securities Act § 5(b), 15 U.S.C. § 77e(b) (1994).

¹⁰ *See* Securities Act § 2(10), 15 U.S.C. § 77b(10) (1994). The Supreme Court created some uncertainty about the precise meaning of the word "prospectus" in *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995), in which it held that section 12(2) of the Securities Act, (codified as amended as 15 U.S.C.A. § 77l(a)(2) (1996 Supp.)), does not apply to privately negotiated secondary transactions.

¹¹ *See* Investment Company Act § 7, 15 U.S.C. § 80a-7 (1994).

¹² *See* Securities Act § 2(3), 15 U.S.C. § 77b(3) (1994); Investment Company Act § 2(34), 15 U.S.C. § 80a-2(34) (1994).

¹³ Various exemptions from Securities Act and Investment Company Act registration may be available in some cases, but many investment management arrangements would not qualify for those exemptions. Each of those exemptions contains restrictions, including restrictions on advertising and sales to small or unsophisticated investors. *See generally* THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* §§ 4.1-.29, 17.1, 17.3 (3d ed. 1995); 2 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 1211-60, 1274-1454 (3d ed. 1989). More important, exemptions cannot be combined, so all transactions in an offering or issue of securities must satisfy a single exemption; if one does not, none does. *See* Cheryl L. Wade, *The Integration of Securities Offerings: A Proposed Formula that Fosters the Policies of Securities Regulation*, 25 LOY. U. CHI. L.J. 199, 199 (1994); *cf.* Securities Act Rules §§ 504(b)(2), 505(b)(2)(I), 17 C.F.R. §§ 230.504(b)(2), .505(b)(2)(I) (1995) (providing dollar amounts for Regulation D offerings). It is difficult to predict whether transactions will be integrated and treated as a single offering, and the prospect of apparently separate accounts being integrated makes it difficult to rely upon these exemptions to sell investment management services.

regulation of those in the securities business. The SEC and the National Association of Securities Dealers regulate securities brokers and dealers, and their regulations govern the details of broker-dealer operations.¹⁴ Those who advise others as to the advisability of investing in securities for compensation are also subject to the Investment Advisers Act.¹⁵ This act requires registration and periodic reporting, and also regulates investment adviser compensation.¹⁶

Finally, the antifraud provisions of the federal securities laws independently control the form and substance of information that investment managers make available to prospective clients.¹⁷ Moreover, while investment managers may not technically be in a fiduciary relationship with prospective clients before they assume office, the securities laws impose something very much akin to fiduciary responsibility even during the promotional phase of an investment management relationship.¹⁸

B. The Context in Which the Securities Laws Have Been Applied to Investment Management Arrangements

Much of the law that determines whether investment management arrangements are securities was made in the early 1970s. That law developed largely in response to practices in two businesses that are themselves subject to extensive federal regulatory schemes: commodities trading and commercial banking. Since the early 1970s, commodities law and banking law have changed to address the problems posed by those practices directly, but the legal doctrines developed in the early 1970s still largely control the question of whether any investment management arrangement is a security for the purposes of the federal securities laws.

The first development that led to an expansion of the definition of the word security in the early 1970s was that nonagricultural commodities began to be widely traded on commodity exchanges, at a time when such commodities were

¹⁴ See Exchange Act §§ 15, 15A, 15 U.S.C. §§ 78o, 78o-3 (1994). See generally DAVID A. LIPTON, *BROKER-DEALER REGULATION* (1995); JERRY W. MARKHAM & THOMAS LEE HAZEN, *BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW* (1995); Alexander C. Dill, *Broker-Dealer Regulation Under the Securities Exchange Act of 1934: The Case of Independent Contracting*, 1994 COLUM. BUS. L. REV. 189, 208-28.

¹⁵ See Investment Advisers Act § 202(11), 15 U.S.C. § 80b-2 (1994) (providing the definition of investment adviser).

¹⁶ See generally TAMAR FRANKEL, *THE REGULATION OF MONEY MANAGERS* (1978); HAZEN, *supra* note 13, ch. 18.

¹⁷ See HAZEN, *supra* note 13, § 1.2.

¹⁸ See generally NORMAN S. POSER, *BROKER-DEALER LAW AND REGULATION* ch. 3 (1995) (discussing broker-dealer fraud under the federal securities laws).

largely unregulated under the commodities laws.¹⁹ To obtain a remedy in federal court, commodity investors who felt they had been wronged argued that their commodity trading accounts were securities, and many federal courts agreed.²⁰ Since then, the commodities laws have been repeatedly amended to police fraud in commodities dealing directly.²¹ Even if the remedies that commodity investors have been extended over the last twenty years are less generous than those available to security investors, it is unlikely that courts would have extended the scope of the federal securities laws as much as they did in the early 1970s if the remedies now available under commodities law had been available then.²² Nonetheless, the expansive scope that some courts gave to the securities laws still stands, and it provides the framework for determining whether any investment management arrangement is a security today.

The other important development that transformed the scope of the federal securities laws in the early 1970s was that commercial banks tried to offer investment management services to individuals in a manner that would have competed with—and to a substantial extent substituted for—mutual funds.²³ The mutual funds responded by arguing that these services were securities that the banking laws forbade commercial banks to offer.²⁴ The SEC responded by insisting that the arrangements were securities that had to be registered under the federal securities laws.²⁵ The banking-law argument met with mixed

¹⁹ See 1 PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, *COMMODITIES REGULATION* § 1.79 (2d ed. 1989).

²⁰ See 2 LOSS & SELIGMAN, *supra* note 13, at 928–30; see also cases cited *infra* notes 58–76.

²¹ See 7 U.S.C. §§ 9, 9a, 13, 13a, 13a-1, 13a-2, 13b, 18 (1994); see also *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982) (finding private right of action implicit under Commodities Exchange Act); JOHNSON & HAZEN, *supra* note 19, §§ 1.83–.84, 4.145–.190.

²² The Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, (88 Stat. 1389, 1974) (“CFTCA”), substantially reduced SEC jurisdiction over commodities transactions, giving the Commodity Futures Trading Commission “exclusive jurisdiction . . . with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery” 7 U.S.C. § 2(a)(1)(A) (1994). Although courts continue to hold that managed commodities accounts may be securities, some commentators read the CFTCA to have established that commodities accounts are not securities. See 2 JOHNSON & HAZEN, *supra* note 19, § 4.41, at 282–83; cf. 2 LOSS & SELIGMAN, *supra* note 13, at 1072–80 (discussing treatment of commodity accounts).

²³ See *infra* Parts II.C and III.

²⁴ See Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672 (1987); see also *infra* Part II.C.

²⁵ See *infra* Part III.

success,²⁶ but the banks largely went along with the SEC and either altered their programs²⁷ or registered them under the Securities Act and the Investment Company Act.²⁸ This compliance effort has no doubt been expensive for the banks, but it has implications far beyond banking. The SEC's theory of why investment management arrangements may be securities was not limited to arrangements offered by banks, and the position to which the banks acquiesced, like the law that courts developed to deal with commodities fraud, continues to stand as a test of whether any investment management arrangement is a security.

Scholars have offered the law's response to the growth of investment management activities as a paradigm of legal evolution and the problem of statutory obsolescence.²⁹ The issues raised by public trading of nonagricultural commodities and commercial-bank investment management activities were eventually addressed as commodities law and banking law questions. Unfortunately, the initial attempt to resolve those issues by expanding the definition of the term security created a new set of problems for the field of investment management. The expanded definition still governs the treatment of a wide variety of investment management arrangements under the securities laws, although these arrangements are often structured in apparent disregard of the possibility that they are securities. Moreover, disagreements about the meaning of the word security were never resolved, perhaps because the commodities and banking problems were eventually addressed elsewhere. Thus, the meaning of the word security, especially as it applies to investment management arrangements, remains unclear, and it is often difficult to determine whether a particular investment management arrangement is subject to the federal securities laws.

II. INVESTMENT MANAGEMENT ARRANGEMENTS AS SECURITIES

When an investment management arrangement is packaged as a conventional security, such as a share of common stock, the federal securities laws are clearly implicated in the marketing of the arrangement. Shares in an open-end investment company—popularly called a mutual fund—are an example.³⁰ Such shares are subject to the registration requirements of the Securities Act; the investment company is subject to the Investment Company Act; the manager of the company is subject to the Investment Advisers Act;

²⁶ See Langevoort, *supra* note 24; Willis, *supra* note 1; see also *infra* Part II.C.

²⁷ See *infra* text accompanying notes 30–34.

²⁸ See *infra* note 164.

²⁹ See Clark, *supra* note 1; Langevoort, *supra* note 24.

³⁰ See *infra* note 151.

brokers and dealers selling the shares are subject to the Exchange Act; and the antifraud provisions of the several federal securities statutes govern distribution of the shares.³¹ Those involved in the marketing and management of mutual funds presumably comply with the pervasive regulatory regime in which they operate, and they are at least on fair notice of its existence. Other investment management arrangements may also be securities; however, as the case law shows, investment managers often fail to take account of that possibility.

The Supreme Court frequently characterizes the federal securities statutes as remedial statutes that are to be broadly construed in determining whether an investment vehicle is a security.³² So commissioned, federal courts and the SEC have read the definition of security in the several federal securities statutes to include various arrangements between investment managers and their clients,³³ and the Court itself has held some investment management arrangements to be statutory securities.³⁴ Nevertheless, the reach of the federal securities laws has ebbed and flowed over time, and the meaning of the term security is still open in many of its particulars. However, while the route to classification of investment management arrangements as securities is not always clearly marked, it has been traveled enough to leave its broad contours familiar.

The Securities Act, the Exchange Act, and the Investment Company Act all define the word security by listing various instruments that are securities, and each list includes the term "investment contract."³⁵ The Supreme Court

³¹ See *supra* notes 10–16.

³² See, e.g., *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); see also *Reves v. Ernst & Young*, 494 U.S. 56, 60–61 (1990); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). But see *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982).

³³ State courts have followed suit. See, e.g., *New York v. First Meridian Planning Corp.*, 86 N.Y.2d 608 (1995) (resulting in criminal conviction).

³⁴ See *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) (holding prematurity phase of flexible fund annuities are securities); *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) (holding variable annuities are securities); see also *Howey*, 328 U.S. at 293; cf. *Investment Co. Inst. v. Camp*, 401 U.S. 617 (1971) (holding that interest in collective investment fund is a security for purposes of Glass-Steagall Act).

³⁵ Securities Act § 2(1), 15 U.S.C. § 77b(2)(1) (1994); Exchange Act § 3(a)(10), 15 U.S.C. § 78c(a)(10)(1994); Investment Company Act § 2(a)(36), 15 U.S.C. § 80a-2(a)(36)(1994); see also Investment Advisers Act § 202(18), 15 U.S.C. § 80b-2(18) (1994) (similar definition). The courts have held that the word security generally means the same thing in the Securities Act and the Exchange Act. See *Marine Bank v. Weaver*, 455 U.S. 551, 555 n.3 (1982); *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 335–36, 342 (1967); see also *Reves v. Ernst & Young*, 494 U.S. 56, 60 n.1 (1990) ("We have consistently held that 'the definition of a security in § 3(a)(10) of the 1934 Act . . . is virtually identical [to the definition in the Securities Act]

elaborated the meaning of that term in *SEC v. W.J. Howey Co.*,³⁶ in which it said that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."³⁷

The meaning of the term investment contract has been much litigated since *Howey*. It is by no means settled now, and the elements of the Court's test have acquired substantial gloss.³⁸ Nonetheless, the Court defined the term broadly

and, for present purposes, the coverage of the two Acts may be considered the same.' We reaffirm that principle here.") (quoting *Forman*).

The word security has even broader duty in the Investment Company Act than in the other federal securities statutes, and regulated parties sometimes have an incentive to claim that investments are securities. See, e.g., Putnam Diversified Premium Income Trust, SEC No-Action Letter, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,325 (July 10, 1989). The relationship between the definitions in the Investment Company Act and the other federal securities statutes is accordingly somewhat complicated. However, the test of investment contract under the Exchange Act is often cited as the test under the Investment Company Act. See, e.g., H.R. REP. NO. 333, 104th Cong., 1st Sess. 5-6 (1995), reprinted in 1995 U.S.C.C.A.N. (109 Stat. 682) 619, 621; Investment Co. Act Release No. 11,016, [1989-1990 Transfer Binder] 5 Fed. Sec. L. Rep. (CCH) ¶ 47,374, at 36,378 (Jan. 10, 1980); see also FRANKEL, *supra* note 16, § F21, at 277. Any investment vehicle that is a security for purposes of the Securities Act or the Exchange Act is a security for purposes of the Investment Company Act. See *SEC v. American Bd. of Trade*, 593 F. Supp. 335, 340 (S.D.N.Y. 1984) (holding that if an investment is a security for purposes of the Securities Act, it is also a security under the Investment Company Act), *rev'd on other grounds*, 751 F.2d 529 (2d Cir. 1984); *Sanders v. John Nuveen & Co.*, 463 F.2d 1075, 1077-78 (7th Cir. 1972) (holding that the definition of security in Investment Company Act is relevant in interpreting definition in Exchange Act). The question is whether investment vehicles may be securities for purposes of the Investment Company Act even if they are not securities for purposes of the other federal securities statutes. See *Putnam Diversified*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,325, at 79,209-10.

³⁶ 328 U.S. 293 (1946).

³⁷ *Id.* at 298-99.

³⁸ Many commentators have criticized the resulting complexity and uncertainty. See, e.g., HAZEN, *supra* note 13, § 1.5, at 31-33; 2 LOSS & SELIGMAN, *supra* note 13, at 870-71; Thomas Arnold, "When Is a Car a Bicycle?" and Other Riddles: The Definition of a Security Under the Federal Securities Laws, 33 CLEV. ST. L. REV. 449 (1984); William J. Carney, *Defining a Security: The Addition of a Market-Oriented Contextual Approach to Investment Contract Analysis*, 33 EMORY L.J. 311 (1984); Williamson B.C. Chang, *Meaning, Reference and Reification in the Definition of a Security*, 19 U.C. DAVIS L. REV. 403 (1986); Ronald Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367 (1967); Dennis S. Corgill, *Securities as Investments at Risk*, 67 TUL. L. REV. 861 (1992); Scott FitzGibbon, *What Is a Security? — A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893 (1980); James D.

and further emphasized that its definition "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of money of others on the promise of profits."³⁹ Moreover, federal courts faced with a perceived wrong may stretch to hold an investment to be a security in order to provide a federal remedy. In any event, many investment management arrangements have been held to be securities. Such arrangements take many forms, however, and it may be difficult to predict whether a court will characterize a particular arrangement as a security, especially given the disarray about what an investment contract is.

Judicial inquiry into whether a particular investment management relationship is a security usually focuses on one or more of the sometimes intertwined elements of *Howey*'s definition of an investment contract, although, in practice, examination of the interaction of the various attributes of an investment vehicle may offer a better prediction of its ultimate characterization than a checklist approach.⁴⁰ In any event, in disputes over whether investment management arrangements are investment contracts, and thus securities, three questions recur: (1) Is there a common enterprise?; (2) is the investor relying on the manager to produce profits?; and (3) does the use of a trust change the analysis?

A. Common Enterprise

The requirement that an investment contract be a common enterprise is probably the most unsettled element of the *Howey* test.⁴¹ Although some

Gordon III, *Common Enterprise and Multiple Investors: A Contractual Theory for Defining Investment Contracts and Notes*, 1988 COLUM. BUS. L. REV. 635; Lewis D. Lowenfels & Alan R. Bromberg, *What Is a Security Under the Federal Security Laws?*, 56 ALB. L. REV. 473 (1993); Park McGinty, *What Is a Security?*, 1993 WIS. L. REV. 1033; Randall Quinn & Paul Gonson, *Development of the Securities Law in the Supreme Court: The Definition of "Security" and the Implication of Private Rights of Action*, 35 HOW. L.J. 319 (1992); Marc I. Steinberg & William E. Kaulbach, *The Supreme Court and the Definition of "Security": The "Context" Clause, "Investment Contract" Analysis, and Their Ramifications*, 40 VAND. L. REV. 489 (1987); Maura K. Monaghan, Note, *An Uncommon State of Confusion: The Common Enterprise Element of Investment Contract Analysis*, 63 FORD. L. REV. 2135 (1995).

³⁹ *Howey*, 328 U.S. at 299.

⁴⁰ See HAZEN, *supra* note 13, § 1.5, at 31, 34; see also James D. Gordon III, *Interplanetary Intelligence About Promissory Notes as Securities*, 69 TEX. L. REV. 383 (1990).

⁴¹ See HAZEN, *supra* note 13, § 1.5, at 34-35; Gordon, *supra* note 38; Monaghan, *supra* note 38; F.S. Tinio, Annotation, *What Is an "Investment Contract" Within the Meaning of § 2(1) of the Securities Act of 1933, Defining the Term "Security" as Including an*

apparently discordant cases can be reconciled on their facts, the case law on common enterprise leaves investors and managers with little clear guidance on the scope of the federal securities laws. Some courts have essentially eliminated the requirement of common enterprise as a meaningful limitation on the scope of investment contract, and some commentators would eliminate it explicitly. Much of the difficulty has arisen in cases presenting the question whether discretionary brokerage accounts constitute a common enterprise,⁴² but the various tests developed in the lower courts show little sensitivity to the way such accounts operate.

The Supreme Court said little about the common-enterprise element in *Howey*. In that case, a corporation that owned citrus groves in Florida offered to sell investors fee simple interests in the land of a grove,⁴³ and an affiliated corporation offered to enter into service contracts for the management of the investors' trees and crops.⁴⁴ The Court held that this constituted the offering of securities, even though investors were free to buy the land without entering into a service agreement with the promoters.⁴⁵ The Court discussed the relevance of a common enterprise only in the course of explaining why the investments being offered were "something more than fee simple interests in land, something different from a farm or orchard coupled with management services."⁴⁶ The difference, according to the Court, was in the fact that

individual development of the plots of land that are offered and sold would seldom be economically feasible due to their small size. Such tracts gain utility as citrus groves only when cultivated and developed as component parts of a larger area. A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments.⁴⁷

The presence of a common enterprise may distinguish investment contracts that are securities from fruit orchards that are not, but courts called upon to classify investment management arrangements have found little guidance in *Howey*. Lower courts have developed three tests of commonality, which are—at least on their express terms—largely irreconcilable.⁴⁸

Investment Contract, 3 A.L.R. FED. 592 (1970).

⁴² See HAZEN, *supra* note 13, § 1.5, at 53-56; 2 LOSS & SELIGMAN, *supra* note 13, at 927-35; Gordon, *supra* note 38, at 635-42; Monaghan, *supra* note 38, at 2152-71.

⁴³ See *Howey*, 328 U.S. at 295.

⁴⁴ See *id.*

⁴⁵ See *id.* at 300.

⁴⁶ *Id.* at 299.

⁴⁷ *Id.* at 300.

⁴⁸ In 1985, three justices dissented from the denial of certiorari in *Mordaunt v. Incomco*,

1. *Horizontal Commonality*

Setting a high threshold for the common-enterprise requirement would exclude most investment management arrangements from classification as investment contracts, at least absent pooling of managed assets and collective management.⁴⁹ For a while, the SEC and the courts seemed intent on doing just that.⁵⁰ For example, in *Milnarik v. M-S Commodities, Inc.*,⁵¹ Judge (later Justice) Stevens of the Seventh Circuit rejected the argument that a discretionary account for trading in commodity futures was a common enterprise and hence a security.⁵² Although the plaintiffs alleged that the broker had entered into similar arrangements with other customers, that was not enough to make the plaintiffs' account a security.⁵³ The investors in the several accounts "were not joint participants in the same investment enterprise,"⁵⁴ and because the plaintiffs' profits were not dependent upon those of other customers, the accounts were not securities.⁵⁵

The Third and Seventh Circuits have joined the Sixth Circuit in adopting this most restrictive test of the common-enterprise requirement of *Howey*, the requirement of horizontal commonality among various investors.⁵⁶ Under this

686 F.2d 815 (9th Cir. 1982), *cert. denied*, 469 U.S. 1115 (1985), which held that a discretionary commodity account was not a security. They argued that certiorari should have been granted "[i]n light of the clear and significant split in the Circuits." 469 U.S. at 1117. This dissent contains a tight description of the various tests the circuits have developed, which are discussed below.

⁴⁹ A pooled investment vehicle is one in which all contributions of investors are treated as part of the same unit and the interests of investors are represented by participations in that unit. Common examples of pooled investment vehicles are commingled trust funds and investment companies.

⁵⁰ Despite the well-known existence of discretionary management services, the SEC has apparently never acted, either through enforcement or through its rulemaking authority, to have individual discretionary accounts registered as securities absent a common investment management scheme. For example, in 1970, the SEC attacked a managed account arrangement as a security on the ground, among others, that investment decisions were being implemented in all accounts on a uniform basis, but not simply on the ground that the accounts were being managed on a discretionary basis. *See SEC v. First Nat'l City Bank*, SEC Litigation Release No. 4534, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,592 (Feb. 6, 1970); *see also infra* text accompanying note 211 (discussing Release No. 4534).

⁵¹ 457 F.2d 274 (7th Cir. 1972).

⁵² *See id.* at 279.

⁵³ *See id.*

⁵⁴ *Id.* at 277.

⁵⁵ *Id.* at 276-77.

⁵⁶ *See Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016, 1017 (7th Cir. 1994); Deckebach

approach, which has been held to require that several investors' funds be pooled,⁵⁷ conventional discretionary accounts, in which a manager makes investment decisions for a particular investor's account, are not securities, and even more exotic arrangements can be structured to avoid their being classified as securities.

2. Broad Vertical Commonality

Notwithstanding *Milnarik* and similar cases, there were indications even before *Howey* that a managed investment account, at least one over which the manager had discretionary authority, may be an investment contract.⁵⁸ Another

v. La Vida Charters, Inc., 867 F.2d 278, 283 (6th Cir. 1989); *Hart v. Pulte Homes of Mich. Corp.*, 735 F.2d 1001, 1003 (6th Cir. 1984); *Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 682 F.2d 459, 460 (3d Cir. 1982); *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 219 (6th Cir. 1980), *aff'd*, 456 U.S. 353 (1982).

⁵⁷ See *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 277-78 (7th Cir. 1972); see also *Wals*, 24 F.3d at 1017; *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96, 99 (7th Cir. 1977); *Meredith v. Conticommodity Servs., Inc.*, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,701, at 98,672 (D.D.C. 1980); *Darrell v. Goodson*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,349 (S.D.N.Y. 1980); *Wasnowic v. Chicago Bd. of Trade*, 352 F. Supp. 1066, 1067 (D. Md. 1972), *aff'd*, 491 F.2d 752 (3d Cir. 1973); cf. *Curran*, 622 F.2d at 219 (holding commodities account was not a security even though broker falsely represented it would be pooled), *aff'd on other grounds*, 456 U.S. 353 (1982). But cf. *SEC v. Lauer*, 52 F.3d 667, 670 (7th Cir. 1995) (holding that an investment in a fraudulent scheme that was supposed to involve pooling but only succeeded in attracting one investor was a security: "[I]t is the character of the investment vehicle, not the presence of multiple investors, that determines whether there is an investment contract.").

⁵⁸ Thus, in 1935 one court wrote that

Whether one invests money in the proverbial gold mine, . . . or invests in a speculative venture by reason of the claimed skill and experience of a grain and stock market manipulator to make profits, the transactions cannot be rationally distinguished in determining the dealings which Congress intended to regulate in using the term "investment contract." Both are investments . . . Both entail the issuance of a security. In one the investor expects profits by reason of the gold to be mined; in the other, by reason of the skill and experience of the defendant in the market. In both, the opportunities for fraud are notorious.

SEC v. Wickham, 12 F. Supp. 245, 248-249 (D. Minn. 1935). After the Supreme Court decided *Howey*, a number of cases came to the same conclusion. See, e.g., *Marshall v. Lamson Bros. & Co.*, 368 F. Supp. 486, 490 (S.D. Iowa 1974); *Johnson v. Arthur, Espey, Shearson, Hammill & Co.*, 341 F. Supp. 764, 765 (S.D.N.Y. 1972); *Berman v. Orimex Trading, Inc.*, 291 F. Supp. 701, 702 (S.D.N.Y. 1968); *Maheu v. Reynolds & Co.*, 282 F.

approach to common enterprise—under which managed accounts are more likely to be classified as securities—requires not horizontal commonality among investors but instead vertical commonality between the investors and the manager or promoter. Most federal courts are satisfied that the common-enterprise requirement of the *Howey* test is satisfied by the presence of horizontal commonality in the form of pooled accounts,⁵⁹ but some courts have held that one or another form of vertical commonality is sufficient even in the absence of horizontal commonality.⁶⁰ Adding to the confusion, however, the courts that are satisfied with vertical commonality do not agree on what constitutes vertical commonality.⁶¹

The SEC emphasized the commonality of discretionary management services offered to various customers in its early forays against managed accounts.⁶² Subsequently, however, the SEC and some courts began to take the position that the reliance an individual investor places in a manager's acumen can itself form the basis of a common enterprise sufficient to satisfy *Howey*. Under the broader test of vertical commonality, it is enough that the investor's success is dependent on the efforts of the manager.

The most influential statement of this approach is probably the Fifth Circuit's 1974 opinion in *SEC v. Continental Commodities Corp.*,⁶³ a case in which the SEC sought to enjoin a firm dealing in commodities futures from violating the registration provisions of the Securities Act and the antifraud provisions of the Exchange Act.⁶⁴ Following *Milnarik*, the district court

Supp. 423, 429 (S.D.N.Y. 1967); cf. *Commercial Iron & Metal Co. v. Bache & Co.*, 478 F.2d 39, 42–43 (10th Cir. 1973); *Booth v. Peavey Co. Commodity Servs.*, 430 F.2d 132, 134 (8th Cir. 1970). See generally HAZEN, *supra* note 13, § 1.5, at 47–50 (citing cases); 2 LOSS & SELIGMAN, *supra* note 13, at 931 n.138 (“Several older cases, often with little analysis, simply assumed that a discretionary commodities account involved a security.”).

⁵⁹ See *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996); see also HAZEN, *supra* note 13, § 1.5, at 33.

⁶⁰ See HAZEN, *supra* note 13, § 1.5, at 33.

⁶¹ See *id.*

⁶² See SEC, *Report of the Advisory Committee on Investment Management Services for Individual Investors, Small Account Investment Management Services*, Fed. Sec. L. Rep. (CCH) No. 465, Pt. III (1973) [hereinafter *Advisory Committee Report*]; SEC Litigation Release No. 4534, *supra* note 211; see also *infra* text accompanying note (discussing Release No. 4534); cf. *Status of Investment Advisory Programs Under the Investment Company Act of 1940*, Investment Company Act Release No. 21,260, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,646 (July 27, 1995).

⁶³ 497 F.2d 516 (5th Cir. 1974).

⁶⁴ The court of appeals described the Continental Commodities' operations as follows:

The trading enterprise extended the opportunity to invest in commodities futures

dismissed the complaint, on the theory that since the accounts of individual investors were unrelated, no security was involved.⁶⁵ The SEC appealed, but only on the theory that notes the firm had issued to its customers were securities.⁶⁶ The court of appeals, however, examined the question of whether the investors were participating in a common enterprise, even though the issue was not contested by the parties.⁶⁷ The court concluded that they were, and accordingly found that the investors' arrangements with Continental were securities.⁶⁸

The Fifth Circuit grounded its rejection of *Milnarik* on its decision in *SEC v. Koscot Interplanetary, Inc.*,⁶⁹ which it had rendered a few days before. *Koscot* held that a multi-level distributorship scheme was an investment contract, and hence a security, even though investors in the distributorship had to contribute their own efforts to accomplish their own success and realized a return that was largely independent of the return to other investors.⁷⁰ According to *Continental Commodities*, the "critical inquiry" in deciding whether a common enterprise is involved

is confined to whether the fortuity of the investments collectively is essentially dependent upon promoter expertise. Continental Commodities renders investment counseling concerning which option on commodities futures to invest in, when to sell or exercise the option, and if the option is exercised, when to sell the specific futures contract. Lacking the business acumen possessed by promoters, investors inexorably rely on Continental

contracts. Continental Commodities undertook to recommend certain commodities futures contracts to its customers. An interested customer would first be issued an option, guaranteeing him the right to purchase the contract at a stated price, with the option to remain open for a specified period of time. Continental Commodities neither owned the underlying futures contract nor escrowed any portion of the customer payments for the purpose of acquiring such contracts. In addition, Continental Commodities undertook to advise a customer of the most opportune moment either to sell or to exercise the option. Finally, it also offered investment counseling as to the most propitious time to sell a specific futures contract.

Id. at 519.

⁶⁵ See *id.* at 521.

⁶⁶ See *id.* at 520.

⁶⁷ See *id.* at 521-23.

⁶⁸ See *id.* at 527.

⁶⁹ 497 F.2d 473 (5th Cir. 1974).

⁷⁰ The primary issue in *Koscot* was whether the *Howey* requirement of an expectation of profits "solely from the efforts of others" was satisfied inasmuch as investors in the distributorship had to contribute their own efforts after investing money. The court held that the *Howey* test was satisfied. See *id.* at 479-85.

Commodities' guidance for the success of their investment. This guidance . . . is uniformly extended to all . . . investors. That it may bear more productive fruits in the case of some options than it does in cases of others should not vitiate the essential fact that the success of the trading enterprise as a whole and customer investments individually is contingent upon the sagacious investment counseling of Continental Commodities.⁷¹

The court's emphasis on the investors' reliance on the defendants' expertise suggests that a broker arranging a single managed account with a single customer may be selling a security, since a single investor can rely on a manager in the same way that many investors can.⁷² On the other hand, the defendants in *Continental Commodities* offered management services to many customers,⁷³ and the action was initiated by the SEC, not by a customer seeking damages.⁷⁴ Moreover, the court's repeated references to "the trading enterprise" might be read to contemplate that a manager's activities can constitute a common enterprise only when they involve several accounts or at least several investors.⁷⁵ Nonetheless, several courts have held that a single customer's managed brokerage account is a security.⁷⁶

⁷¹ *Continental Commodities*, 497 F.2d at 522-23.

⁷² See 2 LOSS & SELIGMAN, *supra* note 13, at 933.

⁷³ See *Continental Commodities*, 497 F.2d at 519.

⁷⁴ See *id.* at 518.

⁷⁵ See Gordon, *supra* note 38 (arguing that *Howey*'s common-enterprise requirement should be interpreted to require multiple parallel investors); cf. *SEC v. Lauer*, 52 F.3d 667 (7th Cir. 1995) (holding that an investment in a fraudulent scheme in which the promoter represented there would be pooling was a security even though the scheme attracted only one investor).

⁷⁶ See, e.g., *Alvord v. Shearson Hayden Stone, Inc.*, 485 F. Supp. 848, 852 (D. Conn. 1980) (holding that a "de facto" discretionary account is a security); *Troyer v. Karcagi*, 476 F. Supp. 1142, 1147 (S.D.N.Y. 1979); *Scheer v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,086 (S.D.N.Y. 1975) (holding commodity futures account to be a security where defendant asserted experience and expertise, and emphasized prospects of a good rate of return to customer who, in fact, always relied upon and followed defendant's advice); *Rochkind v. Reynolds Sec., Inc.*, 388 F. Supp. 254, 255 (D. Md. 1975) (holding commodity futures account to be a security, even absent a "pooling" of funds of several investors, where customer relied solely on broker's expertise in allowing broker to make investment decisions for him); *Johnson v. Arthur, Espey, Shearson, Hammill & Co.*, 341 F. Supp. 764 (S.D.N.Y. 1972); *Berman v. Orimex Trading Co.*, 291 F. Supp. 701 (S.D.N.Y. 1968); *Maheu v. Reynolds & Co.*, 282 F. Supp. 423 (S.D.N.Y. 1967); see also *Moody v. Bache & Co.*, 570 F.2d 523, 526 (5th Cir. 1978) (suggesting that individual discretionary commodities account may be a security, but denying recovery); *HAZEN*, *supra* note 13, § 1.5, at 47-50. But see *Darrell v. Goodson*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,349, at 97,323 (S.D.N.Y. 1980).

3. *Narrow Vertical Commonality*

Continental Commodities and its progeny have been widely criticized by courts⁷⁷ and commentators.⁷⁸ The Ninth Circuit has developed a narrower test of vertical commonality, requiring "that the fortunes of the investors are linked with those of the promoters."⁷⁹ Under this test, it is not enough that the investors are dependent upon the efforts of the manager; the success of the manager and investor must be interdependent. Thus, a discretionary account is not a security if the brokerage firm is compensated only by commissions, since the firm profits even if the client does not.⁸⁰ On the other hand, *Howey's* common-enterprise requirement is satisfied under this test if the manager receives a fee or bonus that is a function of the investor's profits, because the manager's own profit is then "contingent on the profit of his investors."⁸¹

⁷⁷ See *Revak v. SEC Realty Corp.*, 18 F.3d 81, 88 (2d Cir. 1994); *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 233 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982); *Gaudette v. Panos*, 644 F. Supp. 826, 834 (D. Mass. 1986), *complaint dismissed*, 650 F. Supp. 912 (D. Mass. 1987), *complaint ordered reinstated*, 852 F.2d 30 (1st Cir. 1988); *Mechigian v. Art Capital Corp.*, 612 F. Supp. 1421, 1426 (S.D.N.Y. 1985); *Sennett v. Oppenheimer & Co.*, 502 F. Supp. 939, 945 (N.D. Ill. 1980).

⁷⁸ See, e.g., 2 LOSS & SELIGMAN, *supra* note 13, at 933 ("Unless two or more persons in some sense share in the profitability of an undertaking, it is difficult to argue that there is a common enterprise."); *Gordon*, *supra* note 38, at 664-66; *Monaghan*, *supra* note 38, at 2161-62.

⁷⁹ *SEC v. R.G. Reynolds Enters., Inc.*, 952 F.2d 1125, 1130 (9th Cir. 1991) (quoting *SEC v. Goldfield Deep Mines*, 758 F.2d 459, 463 (9th Cir. 1985)); see also *Goldfield Deep Mines*, 758 F.2d at 463 ("A common enterprise is a venture 'in which the 'fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties.'") (quoting *Brodt v. Bache & Co.*, 595 F.2d 459, 460 (9th Cir. 1978), quoting in turn *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973).

⁸⁰ See *Brodt*, 595 F.2d at 459; *Schofield v. First Commodity Corp.*, 638 F. Supp. 4, 7 (D. Mass. 1985), *aff'd*, 793 F.2d 8 (1st Cir. 1986); *Shotto v. Laub*, 635 F. Supp. 835, 839 (D. Md. 1986); see also HAZEN, *supra* note 13, § 1.5, at 33 n.45.

⁸¹ *R.G. Reynolds Enters.*, 952 F.2d at 1131; see also *Goldfield Deep Mines*, 758 F.2d at 463 ("Here, the investors' fortunes were clearly linked with those of appellants. The ore program required the sharing of profits, in that Goldfield [(the promoter)] was to receive a 25% royalty fee for processing the investors' ore. Furthermore, the fortunes of both the investors and appellants were dependent upon the success of appellants' unique ore processing technique. If the processing technique were to prove faulty, then both the investors and appellants would suffer financial losses. This direct correlation between Goldfield's potential failure and the investors' losses supports a finding of a common enterprise."); *Savino v. E.F. Hutton & Co.*, 507 F. Supp. 1225, 1229 (S.D.N.Y. 1981) (finding security where broker was to receive a percentage of investor's profits).

4. *Individual Treatment and Common Enterprise*

While different courts have described the test of common enterprise in widely different terms and have applied very different tests in some cases, opinions that are expressed in irreconcilable terms often reach entirely consistent results. Moreover, the factors that courts have cited to explain themselves in the end draw distinctions that have little to do with the substance of managed accounts.

Although investment management relationships take many forms, courts have not always focused on the nuances of the arrangements before them. For example, the accounts at issue in *Continental Commodities*—the broadest common-enterprise case—were hardly typical brokerage accounts. Usually an investor with a brokerage account owns the assets purchased for the account, and the risk of loss is for all practical purposes solely a function of the wisdom of the investment decision. In *Continental Commodities*, on the other hand, the investors looked to their manager for more than advisory services. Continental placed its clients into naked options written by the firm,⁸² and the litigation grew out of its inability to make good the investors' claims against the firm.⁸³ Accordingly, the investors faced not only the risk that the firm's advice was poor, but also the substantial risk that the firm would be unable to pay their claims even if their investments proved successful. Thus, the decision of the court—if not the language of its opinion—may have turned on the interdependence of the investors and their manager. In light of the investors' reliance on their manager's economic viability, *Continental Commodities* might not have been quite the startling decision that it appeared to be.

⁸² See *Sec v. Continental Commodities*, 497 F.2d 516, 518 (5th Cir. 1974). The SEC has repeatedly indicated that an investor's retention of the indicia of ownership of underlying investments is critical if an investment management arrangement is not to be treated as a security. See Investment Company Act Release No. 21,260, *supra* note 62, at 86,968, 86,973; *Benson White & Co.*, 1995 SEC No-Act. LEXIS 553, at *6 (June 14, 1995); *Wall Street Preferred Money Managers, Inc.*, 1992 SEC No-Act. LEXIS 648, at *2 (Apr. 10, 1992); *West America Co.*, 1991 SEC No-Act. LEXIS 1321, at *1 (Nov. 26, 1991); *Morgan Keegan & Co.*, 1990 SEC No-Act. LEXIS 1168, at *1 (Oct. 2, 1990); *International Asset Management, Inc.*, 1990 SEC No-Act. LEXIS 294, at *2 (Jan. 29, 1990).

⁸³ In essence, the agreements between client and manager were the equivalent of evidences of indebtedness, another type of security under the federal securities laws. See *SEC v. Western Pacific Gold & Silver Exch. Corp.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,064 (D. Nev. 1975) (holding that sales agreements for client investments in gold coins and silver bars constituted "evidences of indebtedness" where clients did not acquire title to the gold or silver, but did acquire claims for money against the defendant, and where clients' moneys were subjected to the "risks of the enterprise"); see also 2 LOSS & SELIGMAN, *supra* note 13, at 900-02.

The SEC has at times suggested that commonality derives from the mutual interest of investors in the financial health of their manager. For example, in a complaint against the Pacific Coast Coin Exchange (PCCE),⁸⁴ the SEC alleged that PCCE sold its clients silver coins and other commodities on margin without purchasing or holding the coins or commodities until the margin accounts were paid in full.⁸⁵ Instead, according to the SEC, PCCE commingled investor funds and subjected them to the risk of the PCCE venture.⁸⁶ In effect, investors became creditors of the firm, an arrangement that might well have been classifiable as the issuance of a security in any event, on the theory that the underlying investment arrangements were evidences of indebtedness.⁸⁷ Investor reliance on the manager's viability was thus arguably the key to the SEC's thinking on common enterprise.⁸⁸ Nonetheless, courts that have followed *Continental Commodities* have ignored the investors' dependence on the continued success of their manager in that case.⁸⁹

In any event, the argument that *Continental Commodities* turned on the investors' reliance on the firm's viability would run into the Fifth Circuit's stated rationale. Although the court apparently understood that the investors' accounts represented investments in both commodities options and the financial health of the firm, it did not emphasize common investment in the firm as a

⁸⁴ SEC v. MONEX Int'l Ltd., SEC Litigation Release No. 6645, 1974 SEC LEXIS 2114 (Dec. 18, 1974) (SEC alleged that a security existed where customers' funds were commingled in defendant's coin-investment enterprise, managed by defendant, subjected to the risks of that enterprise, and where investors relied on defendant's efforts for the safe return of their investments); see also SEC v. MONEX Int'l Ltd., SEC Litigation Release No. 7057, 1975 SEC LEXIS 959 (Aug. 25, 1975) (announcing that a permanent injunction had been granted against the defendants).

⁸⁵ See *MONEX*; 1974 SEC LEXIS at *2.

⁸⁶ See *id.*

⁸⁷ See *Western Pacific Gold & Silver Exch. Corp.*, Fed. Sec. L. Rep. [1974-1975 Transfer Binder] (CCH) ¶ 95,064. The court in *Jenson v. Continental Finance Corp.*, 404 F. Supp. 792 (D. Minn. 1975), also concluded that contracts to purchase gold and silver coins were investment contracts. The opinion places substantially more weight than do *Continental Commodities* and *MONEX* on the degree to which the investors were coventurers with the firm.

⁸⁸ See also *Gary Plastic Packaging Corp. v. Merrill Lynch*, 756 F.2d 230, 240 (2d Cir. 1985) ("The customers [of Merrill Lynch's program of marketing bank certificates of deposit] rely on the skill and financial stability of Merrill Lynch . . .").

⁸⁹ The Fifth Circuit followed and reaffirmed *Continental Commodities* in *Long v. Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989). The court did not suggest that the promoter's viability was in doubt in *Long*, and the court again focused on the investors' reliance on the promoter's expertise. *Id.* at 140-41.

basis for concluding that the accounts were securities.⁹⁰ Instead, the court explained its decision by emphasizing that investment success was “essentially dependent upon promoter expertise,” that guidance was “uniformly extended to all . . . investors,” and that the results of the enterprise as a whole and customer investments individually were “contingent upon the sagacious investment counseling of Continental Commodities.”⁹¹ In sum, the court focused not on the investors’ dependence on the continued viability of the firm, but on the expert advice the promoter promised to provide.

This expertise interpretation of *Continental Commodities* finds support in other cases.⁹² In *SEC v. Brigadoon Scotch Distributors, Ltd.*,⁹³ for example, the court acknowledged that commonality normally implies participation in a common fund, but held that “the requisite commonality of enterprise may also be achieved when ‘the fortunes of all investors are inextricably tied to the efficacy [of the promoters’ efforts].’”⁹⁴ However, if *Howey*’s common-enterprise requirement is satisfied whenever an investor’s profits are affected by the competence of an investment manager, it does little to restrict the scope of the term investment contract. If common enterprise can be shown by the existence of an interest in managerial ability, security status turns largely on the provision of managerial assistance.⁹⁵ Yet the degree of managerial assistance is

⁹⁰ As noted above, in the court of appeals, the SEC argued only that certain notes issued by the firm were securities, and the court reached the common-enterprise question on its own initiative. See *supra* note 60 and accompanying text.

⁹¹ *Continental Commodities*, 497 F.2d at 522–23; see also *Gary Plastic Packaging*, 756 F.2d at 240.

⁹² See, e.g., *Long*, 881 F.2d at 129, 140–41 (reaffirming *Continental Commodities* test of common enterprise); see also *Gary Plastic Packaging*, 756 F.2d at 240.

⁹³ 388 F. Supp. 1288 (S.D.N.Y. 1975).

⁹⁴ *Id.* at 1291 (quoting *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479 (5th Cir. 1974)). *Brigadoon Scotch Distributors* and similar cases support the idea that an arrangement or promotion should be regarded as a statutory investment contract whenever an investor contributes the assets at risk in an investment arrangement and the realization of a return depends primarily on the efforts of the promoter or manager. See *HAZEN*, *supra* note 13, § 1.5, at 62; *Corgill*, *supra* note 38; J. Thomas Hannan & William E. Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 *HASTINGS L.J.* 219 (1974) (emphasizing the importance of the location of the risk of loss and the control of the return on investment); Joseph C. Long, *An Attempt to Return Investment “Contracts” to the Mainstream of Securities Regulation*, 24 *OKLA. L. REV.* 135, 174 (1971) (suggesting that a security should be defined as “the investment of money or money’s worth in the risk capital of a venture with the expectation of some benefit to the investor when the investor has no direct control over the investment or policy decisions of the venture.”); see also *Coffey*, *supra* note 38. The Supreme Court has noted this theory without accepting or rejecting it. See *United Housing Foundation, Inc., v. Forman*, 421 U.S. 837, 857 n.24 (1975).

⁹⁵ Thus, in *Brigadoon Scotch Distributors* the court effectively combined the third-party

precisely the issue raised by the second element of the *Howey* test: Do profits come from the efforts of others?⁹⁶

In the end, however, given the way that accounts are actually managed, the common-enterprise issue is far less polar than these two explanations of the *Continental Commodities* line of cases would suggest. Although opinions involving managed accounts sometimes proceed on the assumption that investment accounts under a single manager have little in common except for the identity of the manager, in fact the investments in managed portfolios typically overlap. Investment managers seldom mimic individuals by seeking investment opportunities account by account. Instead, they evaluate investment opportunities first, and, where action is indicated, identify all accounts suitable for the action.⁹⁷ Although not every investment is made for every account, the correspondence in activity among accounts with similar objectives is typically high. Correspondence tends to increase over time because investment managers necessarily follow only a limited selection of investment opportunities rather than the entire investment universe.⁹⁸ Thus, even if common management is critical to common enterprise, sensitive scrutiny of managed accounts will often reveal it, and the practical realities of investment management that lead to overlapping portfolios will only reinforce commonality.

reliance and common-enterprise elements of *Howey* when it cited a variety of management services, including the initial purchase of rare-coin portfolios and administrative support thereafter, to establish the existence of commonality. See *Brigadoon*, 388 F. Supp. at 1291–92. This approach was compelled by the fact that the only thing all the clients shared was the defendants' professional services.

⁹⁶ See *infra* Part II.B (discussing efforts-of-others requirement). Critics have noted that the broad doctrine of vertical commonality duplicates the efforts-of-others element of the *Howey* test. See, e.g., *Revak v. SEC Realty Corp.*, 18 F.3d 81, 88 (2d Cir. 1994); Gordon, *supra* note 38, at 665. The Fifth Circuit has acknowledged this criticism, but indicated that it will continue to follow *Continental Commodities* nonetheless. See *Long*, 881 F.2d at 140–41.

⁹⁷ See HARVEY E. BINES, *THE LAW OF INVESTMENT MANAGEMENT* ch. 4 (1978) (discussing suitability).

⁹⁸ After the most exhaustive study of managed individual accounts, the SEC's Advisory Committee on Investment Management Services for Individual Investors pointed out that even when clients retain authority to reject or act upon any recommendation, many advisers make blanket recommendations to many of their accounts. While maintaining its position that such accounts should not be subject to formal registration, in the face of this observed disregard of individual client needs, the Committee suggested that the SEC require firms servicing nondiscretionary accounts to describe the basis for all recommendations made to the client in order to enable the client to exercise independent judgment. *Advisory Committee Report*, *supra* note 62, at 25–26; see also *id.* at 33–38 (suggesting disclosure guidelines). Advisers Act Rule 204-3, 17 C.F.R. § 275.204-3 (1995), responds to this concern. See Investment Advisors Act Release No. 664, 1979 SEC LEXIS 2235 (Jan. 30, 1979); see also BINES, *supra* note 97, ¶ 9.03[2][b].

A critical problem that the common-enterprise cases pose for investment management is that ordinary brokerage accounts ought not to be treated as securities, even if the registered representative handling the account recommends investments to the owner. Such accounts have long been common, and if they were supposed to be treated as securities, surely someone would have said so when the federal securities statutes were enacted. On the other hand, some individual brokerage accounts are securities,⁹⁹ and the task is to draw distinctions. Unfortunately, however, the cases simply cannot be reconciled.

If there is a key to all of this, it may be that investment management arrangements are securities unless the manager treats each managed account separately. As the SEC has said in a related context, each account is "managed on the basis of the client's financial situation, investment objectives, and instructions."¹⁰⁰ Using lack of individual treatment as the definition of security probably explains the cases as well as any other test, although it is not the test articulated by the courts. Moreover, this definition offers a distinction between conventional brokerage accounts—in which an investor expects to review and decide upon specific investments as they are made—and accounts employing a special trading system or investment approach—in which the most important decision the investor makes is whether to become involved in the first place.¹⁰¹ Although courts have not offered lack of individual treatment as the test of common enterprise, an individualization test of common enterprise is consistent with both the language of *Howey* as well as the policies underlying the securities laws.¹⁰²

When an investment manager handles all of its accounts the same way regardless of the situations of individual account holders, all the account holders receive common treatment, and thus a test of investment contract that turns on the absence of individual treatment for investors squares with the words the Supreme Court used to define the term in *Howey*: common enterprise.¹⁰³ This

⁹⁹ See sources cited *supra* notes 58, 76 .

¹⁰⁰ Investment Company Act Release No. 21,260, *supra* note 62, at 86,969; see also *infra* Part III.

¹⁰¹ Cf. *Eberhardt v. Waters*, 901 F.2d 1578, 1580–81 (11th Cir. 1990) ("The thrust of the common enterprise test is that the investors have no desire to perform the chores necessary for a return, and are attracted to the investment solely by the prospects of a return.").

¹⁰² See *infra* Part III. The individualization inquiry is like the horizontal approach to common enterprise in that it asks whether several investors are in the same situation, but individualization differs in that it does not ask whether those investors share risks or retain individual ownership of their assets. See *supra* Part II.A.1.

¹⁰³ Professors Loss and Seligman endorse the Ninth Circuit's narrow approach to vertical commonality, in which a security can be found only when profits are shared, whether

test also squares with the little that the Supreme Court said about common enterprise in that case, which was to the effect that a common enterprise is an enterprise in which the interests of all investors are treated alike. As noted above, the Court found that the defendants in *Howey* were offering a common enterprise precisely because "individual development of the plots of land that [were] offered and sold would seldom be economically feasible."¹⁰⁴

A test of common enterprise that treats investments as securities unless the investors receive individualized treatment also furthers the policies underlying the disclosure requirements of the securities laws. While disclosure is an appropriate tool for dealing with the issues created by nonindividualized investment management services, it is not well calculated to address the problems implicated by the factors to which the other tests of common enterprise are keyed. The primary consequence of holding that a particular investment management arrangement is a security is that the manager may have to describe the arrangement in a registration statement and statutory prospectus before proposing it to potential investors.¹⁰⁵ The precise meaning of the term security in difficult cases might be thought to turn on precisely what ends the disclosure provisions of the securities laws are supposed to serve.¹⁰⁶ However, a security has to be something about which meaningful disclosure can be made if the disclosure requirement is to make any sense, or if it is to accomplish anything at all.

If an investment manager proposes to manage accounts according to the individual needs of each investor as those needs change over time, then there is little for the manager to disclose to potential investors when the management relationship is created beyond how the manager will be compensated and how the managed assets will be safeguarded. On the other hand, if a manager proposes to treat all managed accounts alike and employ a common technique for choosing investments, then the registration statement can describe that technique. This technique is precisely that which prospective investors need to know before they hire a manager who will not provide them individualized services. In fact, nonindividualized investment management arrangements are treated as securities only if investors can be assured of getting adequate information about management arrangements when they need it.¹⁰⁷

between investors or between an investor and a promoter. See 2 LOSS & SELIGMAN, *supra* note 13, at 935. This approach does give some meaning to the term common enterprise, but there is no reason the protections of the federal securities laws ought to attach when (and whenever) a manager shares in an investor's profits but not otherwise.

¹⁰⁴ *Howey*, 328 U.S. at 300; see also *supra* text accompanying note 47.

¹⁰⁵ See 15 U.S.C. §§ 77e, 77f, 77j (1994).

¹⁰⁶ See, e.g., Corgill, *supra* note 38; Gordon, *supra* note 38.

¹⁰⁷ See *infra* Part IV.

Finally, lack of individual treatment is an appropriate test of common enterprise as a matter of administrative law. As discussed below, the SEC has looked to individualization to answer the analogous (and perhaps identical) question of whether managed accounts are securities for purposes of determining whether the creator of such accounts is operating an investment company that must register under the Investment Company Act.¹⁰⁸ The SEC's administrative construction is entitled to deference, and it also provides a more coherent body of law than what the courts have provided so far.

In the end, it is hard to fit investment management arrangements into *Howey*'s common-enterprise element. In *Howey*, the element served a function that may not be present in investment management cases.¹⁰⁹ The Supreme Court's task was to distinguish citrus groves that are not securities from complicated management arrangements that are, and common enterprise worked to do so.¹¹⁰ The factors that move courts to treat some investment management arrangements as securities are not always apparent, but whatever they are, they simply are not captured in any idea of commonality. Recognizing as much, some formulations of investment-contract doctrine simply abandon the common-enterprise requirement.¹¹¹ Whether that is an accurate prediction of where the law is going as a general matter, it is at least a fair statement of much of the law governing the status of investment management arrangements.

B. Control Of Investment Decisions

Howey's requirement that profits be expected "solely through the efforts of the promoter or of some one other than themselves"¹¹² ties security status to the control investors retain over their investments. This requirement is illustrated in cases holding limited partnership interests to be securities and general partnership interests not to be.¹¹³ However, the reliance element of the *Howey*

¹⁰⁸ See *infra* Part III.

¹⁰⁹ See *supra* note 46 and accompanying text.

¹¹⁰ See SEC v W.J. Howey Co., 328 U.S. 293, 299-300 (1946).

¹¹¹ See HAZEN, *supra* note 13, § 1.5, at 53.

¹¹² *Howey*, 328 U.S. at 298.

¹¹³ Compare *Holden v. Hagopian*, 978 F.2d 1115 (9th Cir. 1992) (plaintiffs failed to plead allegations sufficient to establish that their general partnership interests were securities) and *Klaers v. St. Peter*, 942 F.2d 535 (8th Cir. 1991) (holding that particular general partnership interest was not a security) and *Stewart v. Raglan*, 934 F.2d 1033 (9th Cir. 1990) (same) and *Banghart v. Hollywood General Partnership*, 902 F.2d 805 (10th Cir. 1990) (same) and *Hirsch v. duPont*, 396 F. Supp. 1214 (S.D.N.Y. 1975) (holding that general partnership interest was not a security because partners all vested with complete managerial control), *aff'd*, 553 F.2d 750 (2d Cir. 1977) with *Reeves v. Teuscher*, 881 F.2d 1495 (9th Cir. 1989) (holding that limited partnership interests were securities, general partnership

test has been substantially refined, so that the "solely" requirement does not preclude all investor participation. It is now sufficient if the "efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."¹¹⁴ Franchising arrangements, for example, may be securities even if the franchisees are not totally passive. Instead of insisting on abject dependence, courts focus on the extent to which the promoter or a third party is involved in the subsequent management of the franchised business.¹¹⁵ Thus, a franchise is

interest was not) *and* SEC v. Interlink Data Network, 1993 U.S. Dist. LEXIS 20163 (C.D. Cal. 1993) (holding that limited partnership interest was a security) *and* Sampson v. Invest America, Inc., 754 F. Supp. 928 (D. Mass. 1990) (holding that limited partnership interests were securities) *and* Herman v. Doug Frank Dev. Corp., 385 F. Supp. 767 (S.D.N.Y. 1974) (holding that limited partnership interest was a security). *But see* Stone v. Kirk, 8 F.3d 1079 (6th Cir. 1993) (holding that interest in joint venture-general partnership that leased master recordings was a security); Koch v. Hankins, 928 F.2d 1471 (9th Cir. 1991) (holding that interest in general partnership may be a security); Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981) (holding that although there is a strong presumption against characterizing general partnerships as securities, it is appropriate to do so where the agreement leaves the investor with little power, where the investor is so inexperienced in business affairs as to be incapable of exercising power, or where the investor is so dependent on the unique skills of the promoter as to be incapable of exercising power); K.B.R. Inc. v. L.A. Smoothie Corp., 1995 U.S. Dist. LEXIS 15973 (E.D. La. Oct. 26, 1995) (holding that joint venture interest may be a security). *See generally* HAZEN, *supra* note 13, § 1.5, at 50-51 (collecting cases).

¹¹⁴ SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973); *see also* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975) ("The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."); SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir. 1996) (discussing profits "predominantly" from the efforts of others); Monaghan, *supra* note 38, at 2147-48 (collecting cases). *See generally* HAZEN, *supra* note 13, § 1.5, at 31-32; 2 LOSS & SELIGMAN, *supra* note 13, at 941-48.

¹¹⁵ *See, e.g.,* Meyer v. Dans un Jardin, S.A., 816 F.2d 533 (10th Cir. 1987) (holding that boutique franchise was not a security); Villeneuve v. Advanced Bus. Concepts Corp., 730 F.2d 1403 (11th Cir. 1984) (en banc) (distributorship for sale of self-watering planters was not a security); Bitter v. Hoby's Int'l, Inc., 498 F.2d 183 (9th Cir. 1974) (holding that restaurant franchise was not a security since franchisees responsible for day-to-day management and operation of restaurant, despite strict franchise guidelines); Nash & Assocs., Inc. v. Lum's of Ohio, Inc., 484 F.2d 392 (6th Cir. 1973); Mr. Steak, Inc. v. River City Steak, Inc., 460 F.2d 666, 670 (10th Cir. 1972) (holding that restaurant franchise was not a security); Gotham Print, Inc. v. American Speedy Printing Centers, Inc., 863 F. Supp. 447 (E.D. Mich. 1994) (holding that master franchise for printing stores was not a security); SEC v. Bull Inv. Group, Inc., [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,010 (D. Mass. 1975) (holding that arrangement whereby local "dealers" (franchisees) would solicit new customers in return for a commission was a security because ultimate success or failure of the recruitment depended upon franchiser's sales-presentation efforts); L.H.M., Inc.

not a security if the franchisee will be largely responsible for running it, even if the franchiser will help start the franchised business.¹¹⁶ On the other hand, franchise programs may be securities when the franchiser is largely responsible for selling to the franchisee's potential customers.¹¹⁷

Courts have taken a similar approach to investment management services. For example, the classification of accounts invested in precious metals or rare coins depends on the extent to which buyers rely on someone else to accomplish their investment aims. Thus, those who simply sell precious metals to commercial buyers and investors are not selling securities;¹¹⁸ nor are coin dealers who sell their inventory to bona fide numismatists.¹¹⁹ Buyers of precious metals and coins have been held to have bought securities, however, when they have relied on the promoters to produce the product or given substantial weight to their opinions and recommendations about how to minimize risk while maximizing the chance of appreciation.¹²⁰

v. Lewis, 371 F. Supp. 395 (D.N.J. 1974) (holding that theater franchise was not a security due to participants' "significant contributions" to the management and operation of the theater), *aff'd*, 510 F.2d 970 (3d Cir. 1975); Mitzner v. Cardet Int'l Inc., 358 F. Supp. 1262 (N.D. Ill. 1973) (holding that distributorship franchise was a security where franchisee's role was purely mechanical and ministerial, devoid of any power to make "meaningful or independent business decisions"). See generally 2 LOSS & SELIGMAN, *supra* note 13, at 971-77; Kathy J. Tidd, *Is a Franchise Also a Security?*, FRANCH. L.J., Winter 1988, at 1.

¹¹⁶ See, e.g., Meyer, 816 F.2d 533; see also A.B.A. Auto Lease Corp. v. Adam Indus., Inc., 387 F. Supp. 531 (E.D. Pa. 1975); cf. SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir. 1996) (holding that pre-investment assistance was insufficient to satisfy *Howey*).

¹¹⁷ See, e.g., SEC v. Bull Inv. Group, Inc., [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,010 (D. Mass. 1975); see also SEC v. Aqua-Sonic Prod. Corp., 687 F.2d 577 (2d Cir. 1982); Mitzner v. Cardet Int'l, Inc., 358 F. Supp. 1262 (N.D. Ill. 1973); Huberman v. Denny's Restaurants, Inc., 337 F. Supp. 1249 (N.D. Cal. 1972).

¹¹⁸ See, e.g., Mocatta Metals Corp., SEC No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,940 (Aug. 1, 1974); see also SEC v. Belmont Reid & Co., 794 F.2d 1388 (9th Cir. 1986) (gold not yet extracted); Noa v. Key Futures, Inc., 638 F.2d 77 (9th Cir. 1980) (silver bars). But see Commonwealth Silver Exch., Inc., 1975 SEC No-Act. LEXIS 1415 (July 9, 1975) (declining to take no-action position where precious metals would be sold on margin).

¹¹⁹ See Morgan v. Financial Planning Advisors, Inc., 701 F. Supp. 923 (D. Mass. 1988); Steve Ivy Rare Coin Co., [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,233 (June 5, 1975); see also SEC v. Belmont Reid & Co., Inc., 794 F.2d 1388 (9th Cir. 1986) (gold not yet extracted).

¹²⁰ See SEC v. R.G. Reynolds Enters., Inc., 952 F.2d 1125, 1127 (9th Cir. 1991) (finding a gold ore refining venture in which investors depended on promoter's effort to finance, construct, and operate gold refining plant a security); SEC v. Goldfield Deep Mines, 758 F.2d 459, 463 (9th Cir. 1985) (similar); SEC v. Brigadoon Scotch Distribs., Ltd., 388 F. Supp. 1288 (S.D.N.Y. 1975); Commonwealth Silver Exch., Inc., 1975 SEC No-Act. LEXIS

For investment managers, the most important question arising from the requirement that profits be obtained "solely" through the efforts of others is whether complete discretionary authority is necessary for a managed account to acquire security status. Some courts have held that a nondiscretionary account cannot be a security because an investor who retains ultimate control of her own account is not "dependent on the managerial efforts of others."¹²¹ Nonetheless, just as courts have relaxed the "solely" requirement in franchising and pyramid schemes, some have relaxed it in respect of investment management accounts.

In *SEC v. Brigadoon Scotch Distributors, Ltd.*,¹²² which held that the sale

1415 (July 9, 1975) (declining to take no-action position where precious metals would be sold on margin); *Rare Metals Inv. Corp.*, SEC No-Action Letter, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,752 (Feb. 26, 1974) (silver rental program); *cf.* *Coin Vest, Inc.*, SEC No-Action Letter, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,823 (Apr. 8, 1974) (discussing whether contracts relating to coin investments are securities for purposes of Investment Company Act); *New York v. First Meridian Planning Corp.*, 86 N.Y.2d 608 (1995) (state law, following *Howey*). *But see* *SEC v. Belmont Reid & Co., Inc.*, 794 F.2d 1388 (9th Cir. 1986) (holding that gold not yet extracted was not a security).

¹²¹ *Messer v. E.F. Hutton & Co.*, 833 F.2d 909, 915 (11th Cir. 1987) (quoting *Gordon v. Terry*, 684 F.2d 736, 741 (11th Cir. 1982)); *see also infra* text accompanying note 216.

¹²² 388 F. Supp. 1288 (S.D.N.Y. 1975). Some courts have considered the extent of an investment manager's discretion not in the context of deciding whether the investor expected to profit "solely from the efforts of the promoter or a third party." *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946). Instead, they have dealt with discretion in connection with the question of whether there is a common enterprise. Thus, in *Gamble v. Merrill Lynch*, the district court felt that it could avoid deciding whether to adopt narrow or broad vertical commonality as the test of common enterprise, because the account in issue was not discretionary. *Gamble v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,046, at 94,988 (S.D.N.Y. 1982) ("Merrill Lynch was not authorized to bring its investment expertise to bear on the plaintiffs' accounts. Its role was purely ministerial. The complaint alleges only that Merrill Lynch represented that it would fully execute the trades ordered by Karant [(the plaintiffs' trading advisor)] on the plaintiffs' behalf and would correct any mistakes. It did not manage the account, nor was it authorized to make any trades not specified by Karant. There was, therefore, no common enterprise in the arrangement . . ."). In *Alvord v. Shearson Hayden Stone*, 485 F. Supp. 848 (D. Conn. 1980), another court held that an account that was "in essence" discretionary would satisfy the common enterprise element, *See id.* at 853, with the plaintiff bearing the burden of proving that the account was essentially a discretionary one. *Id.* at 852 n.4; *see also* *Berman v. Orimex Trading Co.*, 291 F. Supp. 701 (S.D.N.Y. 1968) (holding that the formal grant of discretion was unnecessary); *Anderson v. Francis I. duPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968).

of rare-coin portfolios was a sale of securities,¹²³ the court took the position that the advisory assistance the defendants provided investors, together with the administrative services they offered, was enough managerial control to satisfy *Howey*.¹²⁴ A general extrapolation of this holding would mean that, even if clients retain authority to approve or disapprove the recommendations of investment managers, their accounts may nonetheless be securities. Indeed even in *Continental Commodities*, so far as appears from the opinion, investors retained the ultimate decision of whether to make specific investments.¹²⁵

Although the Supreme Court may some day say that it really meant "solely" in *Howey*, it is more likely that lower courts will continue to take a liberal position. Liberality is particularly appropriate in analyzing investment management arrangements, for both practical and theoretical reasons. Investment managers are not normally hired with the expectation that their advice will be rejected, so many nondiscretionary accounts share with discretionary accounts a real dependence on the managers' expertise and effective manager control.¹²⁶ Moreover, the fundamental question raised by the entire line of investment management cases is whether the choice of an investment manager is itself an investment so that its promotion should be regulated by treating management arrangements as securities.¹²⁷ If the question is whether investors should be protected at the start of an investment management relationship, then security status should not depend on precisely

¹²³ See *Brigadoon*, 388 F. Supp. at 1293.

¹²⁴ The court did give some weight to the fact that in many instances, the defendants' clients entrusted the actual selection of coins purchased for the client to be made by the defendants' agents in a manner which amounted to discretionary action by the agent. Yet the court held the investment arrangements to be securities, even when the option to allow the agent to select was not exercised, indicating that the crucial factor was that this option had been offered. *Brigadoon*, 388 F. Supp. at 1292.

¹²⁵ In *Messer v. E.F. Hutton & Co.*, 833 F.2d 909 (11th Cir. 1987), the successor court to the Fifth Circuit cited *Continental Commodities* as controlling precedent but stated that a "non-discretionary" account cannot constitute an "investment contract." *Id.* at 915.

¹²⁶ Cf. *Advisory Committee Report*, *supra* note 62, at 19 (describing the position of SEC staff in no-action letters as follows: "Accounts will be treated as discretionary for purposes of determining the applicability of the registration requirements, even if discretionary authority is not given by the customer so long as the customer is given to understand that only through consistently following the adviser's advice will his objective be met or his business welcome or, without such efforts to discourage the exercise of his independent judgment, the customer in fact slavishly follows the adviser's recommendations.").

¹²⁷ The Advisory Committee on Investment Management Services for Individual Investors argued this point in its report to the SEC. See *Advisory Committee Report*, *supra* note 62, at 23-24. The Committee also argued, however, that status as a security should depend on the existence of discretionary authority. See *id.* at 24-25.

ow that arrangement is supposed to be conducted or how it turns out to be conducted, especially since neither party may be certain of what their future relationship will be when they enter into it. There is much to be said on both sides of the question of whether investment management services are securities, but the only argument for drawing the line at the existence of discretionary authority is that there should be an objective basis for determining when the managerial control element of *Howey* has been satisfied. The experience of the franchising cases, however, suggests that courts are not likely to accept the argument that the need for predictability justifies a bright-line rule.¹²⁸

Post-*Howey* legislative developments also suggest that even if discretionary authority is essential, the concept of discretion should be taken to encompass arrangements in which investors retain some control over the way their managers' investment decisions are implemented. For example, section 3(a)(35) of the Exchange Act provides that:

A person exercises "investment discretion" with respect to an account if, directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold by or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder.¹²⁹

Although section 3(a)(35) was added to the Exchange Act as part of a set of provisions regarding brokerage fees paid by fiduciaries and separation of brokerage and money management,¹³⁰ the section reflects a legislative recognition that the possibility of abuse attaches to managed accounts generally, not just the subclass of fully discretionary accounts.

Discretionary accounts and other closely managed accounts are also treated as alike in the Employee Retirement Income Security Act of 1974, which provides that a person is a fiduciary with respect to an employee benefit plan if he either exercises discretionary authority or renders investment advice for

¹²⁸ See *supra* notes 115-17 and accompanying text.

¹²⁹ 15 U.S.C. § 78c(a)(35) (1994).

¹³⁰ See BINES, *supra* note 97, ¶¶ 9.03[2], 10.02; Harvey Bines, *Regulating Discretionary Management: Broker-Dealers as Catalysts for Reform*, 16 B.C. IND. & COM. L. REV. 347, 379-85 (1975); see also Olympia & York Developments, Inc., 1991 SEC No-Act. LEXIS 1189 (Sept. 20, 1991).

compensation.¹³¹ Although again the purpose of this statute was not to settle the question of whether investment management arrangements are securities, it does reflect a legislative determination that discretionary accounts have much in common with other managed accounts, and a decision that investment managers cannot avoid regulation by leaving nominal control over an investment account with their clients.¹³²

C. The Form of the Arrangement: The Status of Trust Relationships

Although the several federal securities statutes refer to investment contracts, no particular form of arrangement between an investment manager and a client is necessary to create a statutory security. In *Howey*, the Supreme Court said that investment contract meant "a contract, transaction or scheme" with certain attributes,¹³³ and since then the term investment contract has demonstrated an amazing capacity to absorb the schemes of promoters however they are constructed. Limited partnerships,¹³⁴ participations in oil and

¹³¹ 29 U.S.C. § 1002(21) (1994).

¹³² The Department of Labor and the Internal Revenue Service have defined investment advice to give meaning to the statutory term fiduciary. See 29 C.F.R. § 2510.3-21 (1995) (Labor); 26 C.F.R. § 54.4975-9 (1995) (I.R.S.). Broadly speaking, a person who makes recommendations about securities gives investment advice if such person either has actual discretionary authority for the plan or provides individualized advisory assistance on a regular basis pursuant to an established understanding that provides that the adviser will render individualized advice for the plan and provides further that such advice will serve as a primary basis for investment decisions. See also *BINES*, *supra* note 97, ¶ 10.03[2]. Whatever the degree of managerial influence necessary to elevate a relationship to status as a security, it is clear that without some influence over an investment program, no security is created. Compare *First Life Assurance Co.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,385 (1976) (holding that investment annuity programs are deemed to be securities because, although company refrained from making investment recommendations, annuitant could invest in securities issued by company, affiliate, or custodian) with *Massachusetts Co., Inc.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,338 (1975) (holding that custodial accounts for transfer of money from fund shares to short-term debt instruments are not securities); see also *Stuyvesant Life Ins. Co.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,294 (1975) (holding that investment annuities are deemed to be securities where issuer participates in decisions on investments).

¹³³ *SEC v. Howey Ct.*, 328 U.S. 293, 298-99 (1946).

¹³⁴ See *supra* note 97 and accompanying text; see also *Bosco v. Serhant*, 836 F.2d 271 (7th Cir. 1987); *Luce v. Edelstein*, 802 F.2d 49 (2d Cir. 1986); *Siebel v. Scott*, 725 F.2d 995 (5th Cir. 1984); *Mayer v. Oil Field Sys. Corp.*, 721 F.2d 59 (2d Cir. 1983); *McGreghar Land Co. v. Meguiar*, 521 F.2d 822 (9th Cir. 1975); *Miltland Raleigh-Durham v. Myers*, 807 F. Supp. 1025 (S.D.N.Y. 1992); *Sampson v. Invest America*, 754 F. Supp. 928 (D. Mass. 1990); *Hirsch v. duPont*, 396 F. Supp. 1214 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d

gas investments,¹³⁵ pyramid schemes,¹³⁶ franchising arrangements,¹³⁷ condominium sales,¹³⁸ and a remarkable variety of other investment arrangements¹³⁹ have all been held to be investment contracts, and a formal agreement has not been required either.¹⁴⁰ In any event, because investment management arrangements in which the manager acts as an agent are typically created by contract, the most significant issue the contract requirement—such as it is—poses for those managing other people's money is the degree to which trusts may be deemed statutory securities.

Neither the SEC nor the courts have been willing to permit the

Cir. 1977); *NYSE v. Sloan*, 394 F. Supp. 1303 (S.D.N.Y. 1975).

¹³⁵ See *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943); *Vale Natural Gas Am. Corp. v. Carrollton Resources*, 795 F. Supp. 795 (E.D. La. 1992).

¹³⁶ See *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974); *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476 (9th Cir. 1973); *SEC v. Steed Indus., Inc.*, [1974–1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,917 (N.D. Ill. 1974); see also *SEC Securities Act Release No. 5211*, 1 Fed. Sec. L. Rep. (CCH) ¶ 1048 (Nov. 30, 1971) (discussing the applicability of the securities laws to multi-level distributorship and pyramid sales plans).

¹³⁷ See *supra* notes 115–17 and accompanying text.

¹³⁸ See *Securities Act Release No. 5347*, 1 Fed. Sec. L. Rep. (CCH) ¶ 1049 (Jan. 4, 1973) (discussing condominium offerings as securities). But see *Revak v. SEC Realty Corp.*, 18 F.3d 81, 88–89 (2d Cir. 1994) (holding a particular condominium offering not to be a security). Similarly, real property interests in vacation developments marketed on their investment appeal may be securities, whereas building lots generally are not. See, e.g., *Rodriguez v. Banco Cent. Corp.*, 990 F.2d 7 (1st Cir. 1993); *Aldrich v. McCulloch Props., Inc.*, 627 F.2d 1036 (10th Cir. 1980); *Pliskin v. Bruno*, 838 F. Supp. 658 (D. Me. 1993). According to the SEC,

condominiums, coupled with a rental arrangement, will be deemed to be securities if they are offered and sold through advertising, sales literature, promotional schemes or oral representations which emphasize the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, in renting the units.

Securities Act Release No. 5347, 1 Fed. Sec. L. Rep. (CCH) ¶ 1049, at 2071–72 (Jan. 4, 1973); see also *HAZEN, supra* note 13, § 1.5, at 38–39.

¹³⁹ See, e.g., *Smith v. Gross*, 604 F.2d 639 (9th Cir. 1979) (involving earthworm enterprise); *Securities Act Release No. 5018*, 1 Fed. Sec. L. Rep. (CCH) ¶ 1047 (Nov. 4, 1969) (involving whiskey warehouse receipts). See generally *HAZEN, supra* note 13, § 1.5, at 28–29; 2 *LOSS & SELIGMAN, supra* note 13, at 948–56.

¹⁴⁰ See, e.g., *Scheer v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1974–1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,086 (S.D.N.Y. 1975) (holding that no proof of entry into a formal contract was required to classify a discretionary commodities account as a security).

characterization of an investment vehicle as a trust to deter them from applying the securities laws.¹⁴¹ Thus, early in its administration, the SEC obtained an injunction against an unregistered scheme to issue trust certificates, the proceeds of which were to be commingled and used to acquire stock in a bank.¹⁴² As the Supreme Court has sometimes emphasized, substance and economic realities rather than form determine classification as a security,¹⁴³ and the view that the use of the trust form cannot control application of the federal securities laws finds support in the well-established rule that formal compliance with state trust-law requirements cannot control application of federal law.¹⁴⁴

The federal securities statutes themselves indicate that at least some trust interests are securities. The definitions of the word security in the several federal securities statutes do not list trusts or interests in trusts as securities, but the Securities Act, the Exchange Act, and the Investment Company Act all include collateral-trust and voting-trust certificates in their definitions.¹⁴⁵ Similarly, the special treatment accorded to trusts in the definition of the term issuer in the three acts indicates that trusts issue securities, and thus that at least some interests in trusts are securities.¹⁴⁶ The references to trust certificates in

¹⁴¹ See, e.g., *SEC v. Prof'l Assocs.*, 731 F.2d 349 (6th Cir. 1984) (holding that trusts may be securities); *Melton v. Unterreiner*, 575 F.2d 204, 208-09 (8th Cir. 1978) (holding that revocable inter vivos trusts used as method to sell undeveloped real estate are securities); *SEC v. Heritage Trust Co.*, 402 F. Supp. 744, 747-49 (D. Ariz. 1975) (same).

¹⁴² *SEC v. Timetrust, Inc.*, 28 F. Supp. 34 (N.D. Cal. 1939), *appeal dismissed per stipulation*, 118 F.2d 718 (9th Cir. 1941); see also *Independent Bankers' Ass'n*, SEC No-Action Letter, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,198 (Dec. 8, 1972) (two-level collective employee retirement trusts deemed to create a security even though employees received only cash proceeds of the trusts and contributions came exclusively from participating companies). But see *Woodmoor Corp.*, SEC No-Action Letter, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,140 (Apr. 15, 1971) (limited transferability of shares in trust tied to separate ownership deed on real estate placed trustee essentially in position of a custodian; hence, trust participations deemed not to be securities).

¹⁴³ See, e.g., *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990); *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847-51 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946).

¹⁴⁴ See I.R.C. §§ 671-679 (1994) (dealing with treatment of grantor-trusts).

¹⁴⁵ Securities Act § 2(1), 15 U.S.C. § 77b(1) (1994); Exchange Act § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1994); Investment Company Act § 2(a)(36), 15 U.S.C. § 80a-2(a)(36) (1994). See generally 2 LOSS & SELIGMAN, *supra* note 13, at 1050-55, 1062.

¹⁴⁶ See Securities Act § 2(4), 15 U.S.C. § 77b(4) (1994); Exchange Act § 3(a)(8), 15 U.S.C. § 78c(a)(8) (1994); Investment Company Act §§ 2(a)(22) (defining issuer to include person who issues security), 2(a)(28) (defining person to include company), 2(a)(8) (defining company to include trust), 15 U.S.C. §§ 80a-2(a)(22), (28), (8) (1994); see also Securities Act § 3(a)(6), 15 U.S.C. § 77c(a)(6) (involving issuer of equipment-trust certificates);

these definitions might suggest that only trust interests represented by (transferable) certificates are securities.¹⁴⁷ However, section 3(a)(2) of the Securities Act now exempts interests and participations in a variety of single, common, and collective trust funds,¹⁴⁸ and these exemptions would not be necessary if such interests and participations were not securities in the first place.¹⁴⁹

It is well settled that some trust interests are securities,¹⁵⁰ such as shares in mutual funds organized as business trusts.¹⁵¹ On the other hand, ordinary

Securities Act Release No. 97, 1 Fed. Sec. L. Rep. (CCH) ¶ 1021 (Dec. 28, 1933) (involving voting-trust certificates); 2 LOSS & SELIGMAN, *supra* note 13, at 1055-56.

¹⁴⁷ See also Securities Act § 2(2), 15 U.S.C. § 77b(2) (1994) ("As used in this paragraph [i.e., the definition of the term person] the term 'trust' shall include only a trust where the interest or interests of the beneficiary or beneficiaries are evidenced by a security."); H.R. REP. NO. 85, 73d Cong., 1st Sess. 11 (1933) ("The term 'trust' is defined to exclude the ordinary noncommercial trust but to include that type of organization, commonly known as a 'business trust' or a 'Massachusetts trust', which, without resort to the device of incorporation, is used to achieve many of the purposes of the ordinary business corporation."); 2 LOSS & SELIGMAN, *supra* note 13, at 1062.

¹⁴⁸ See 15 U.S.C. § 77c(a)(2) (1994). Section 39(c)(3) of the Investment Company Act provides an analogous exemption for collective trusts.

¹⁴⁹ See 2 LOSS & SELIGMAN, *supra* note 13, at 1062 n.452 ("reading the phrase 'evidenced by a security' [in section 2(2) of the Securities Act] to require that there be some tangible token of the beneficiary's interest in the trust, or that the interest be transferable, would frustrate the legislative purpose, since a business trust could be operated with neither certificates nor free transferability").

¹⁵⁰ See cases cited *supra* note 141.

¹⁵¹ See 2 LOSS & SELIGMAN, *supra* note 13, at 1060-62; Sheldon A. Jones et al., *The Massachusetts Business Trust and Registered Investment Companies*, 13 DEL. J. CORP. L. 421 (1988). The SEC considers real estate investment trusts, which have pass-through tax treatment comparable to that of investment companies, outside the exclusion of section 3(c)(5)(C) of the Investment Company Act, 15 U.S.C. § 80a-3(c)(5)(C) (1994) (involving companies "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate") if they make substantial investments in other such trusts or in companies engaged in the real estate business. See Investment Company Act Release No. 3140, 5 Fed. Sec. L. Rep. (CCH) ¶ 47,356 (Nov. 29, 1960); see also Investment Company Act Release No. 8456, 5 Fed. Sec. L. Rep. (CCH) ¶ 47,357 (Aug. 9, 1974); Manuel F. Cohen & Robert C. Hacker, *Applicability of the Investment Company Act of 1940 to Real Estate Syndications*, 36 OHIO ST. L.J. 482 (1975). The SEC has taken the position that a wide variety of trust interests may be securities. See, e.g., International Asset Management, Inc., 1990 SEC No-Act. LEXIS 294 (Jan. 29, 1990); Morgan Stanley & Co., SEC No-Action Letter, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,337, at 77,066 (Dec. 4, 1985); Northwestern Ohio Bldg. & Constr. Trades Council, SEC No-Action Letter, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,662 (Apr. 20, 1984); Merrill Lynch, SEC No-Action Letter, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,310 (Sept. 28, 1982).

testamentary and irrevocable inter vivos trusts are not generally regarded as securities.¹⁵² Classification may be easy at the extremes. The difficult question is whether an investment management arrangement's status as a trust is relevant to its status as a security.

Some provisions of federal securities law implicitly recognize a structural distinction between trust and agency accounts. A striking example is the contrasting classifications afforded participations in various collective investment vehicles under the Glass-Steagall Act.¹⁵³ National banks are authorized by statute to manage collective trust funds of various types,¹⁵⁴ and, as stated above, participations in many such trusts are exempt from registration under the Securities Act.¹⁵⁵ In *Investment Company Institute v. Camp*,¹⁵⁶ however, the Supreme Court interpreted the Glass-Steagall Act to prohibit banks from managing commingled agency accounts, regardless of compliance with the federal securities laws.¹⁵⁷ Because, as a practical matter, investment management activities on behalf of commingled trust funds are similar to those performed for commingled agency accounts, both of which in turn are managed much like open-end investment companies, the Court's construction of the Glass-Steagall Act suggests an important distinction between the status of participations in trusts on the one hand and agency vehicles on the other.

The precise holding of *Camp* was that participations in commingled agency accounts are securities, and that in marketing such securities, a commercial bank is engaged in underwriting securities, thereby violating the separation of commercial banking and investment banking activities imposed by the Glass-Steagall Act.¹⁵⁸ Of greater moment for purposes of determining whether an investment manager can avoid application of the securities laws by structuring an investment management arrangement as a trust, however, is the Court's citation of the fiduciary nature of trust services as the rationale for distinguishing forbidden participations in commingled agency accounts from permissible investment accounts traditionally managed by the trust departments of commercial banks. Expressing concern over promotional pressures capable

¹⁵² See 2 LOSS & SELIGMAN, *supra* note 13, at 1060-64; see also 1 Frankel, *supra* note 16, § F22, at 281 ("A private trust is not a security.").

¹⁵³ See Banking Act of 1933, ch. 89, 48 Stat. 162 (June 16, 1933) (codified throughout scattered sections of 12 U.S.C., chs. 2, 3, 6).

¹⁵⁴ See 12 U.S.C. § 92a (1994); see also *Investment Co. Inst. v. Camp*, 401 U.S. 617, 624-25 (1971).

¹⁵⁵ See *supra* note 148 and accompanying text; see also Investment Company Act § 3(c)(3), 15 U.S.C. § 80a-3(c)(3) (1994) (stating that bank-maintained common trust funds are not investment companies).

¹⁵⁶ 401 U.S. 617 (1971).

¹⁵⁷ See *id.* at 630.

¹⁵⁸ See *id.* at 639.

of undermining traditional bank conservatism, the Court contrasted client expectations in the establishment of trust accounts with the attitude that might characterize participants in a commingled agency vehicle.¹⁵⁹ Because the demands of the latter group would be for investment return alone, the Court concluded that "there is a plain difference between the sale of fiduciary services and the sale of investments."¹⁶⁰

Camp might be understood to establish that when an investment management arrangement entails fiduciary service, it is not a security, at least for purposes of the Glass-Steagall Act. However, interests in some trusts plainly are securities, even though the trustee owes fiduciary duties to the trust beneficiaries.¹⁶¹ Nor did the Court in *Camp* suggest that every trust activity would survive scrutiny under the Glass-Steagall Act. On the contrary, the Court emphasized that for a long time after the Glass-Steagall Act's enactment, the Federal Reserve Board had permitted banks to use common trust funds only for "strictly fiduciary purposes."¹⁶² While *Camp*'s investment-intent rationale may explain why participations in commingled agency accounts are securities, it does not offer a satisfactory test for determining when participations in trust vehicles are not.

For investment managers trying to minimize the burden of the federal securities laws, the critical task is to determine whether an investment management arrangement that would otherwise be a security will not be if it is structured as some form of a trust. In this respect, *Camp*'s reference to the "true fiduciary purpose"¹⁶³ of a trust relationship may have some bearing,

¹⁵⁹ See *id.* at 638.

¹⁶⁰ See *id.*

¹⁶¹ See *supra* note 151 and accompanying text.

¹⁶² *Camp*, 401 U.S. at 621.

The Board of Governors of the Federal Reserve System which until 1962 had regulatory jurisdiction over all the trust activities of national banks, allowed the collective investment of trust assets only for "the investment of funds held for true fiduciary purposes." The applicable regulation . . . specified that "the operation of such Common Trust Funds as investment trusts for other than strictly fiduciary purposes is hereby prohibited." The Board consistently ruled that it was improper for a bank to use "a Common Trust Fund as an investment trust attracting money seeking investment alone and to embark upon what would be in effect the sale of participations in a Common Trust Fund to the public as investments."

Id. (quoting 26 Fed. Res. Bull. 393 (1940)).

¹⁶³ 401 U.S. at 638 (emphasis added).

[The hazards of a collective investment fund] are all hazards that are not present when a

inasmuch as it suggests that the fiduciary service underlying a trust relationship that is not a security includes much more than a mere investment management service.¹⁶⁴

The distinction the Court drew between commingling trust funds and commingling agency funds suggests that typical testamentary and irrevocable inter vivos trusts may escape security status. While the Court's view of classical trusteeship may not describe the services desired by those establishing institutional and individual revocable trusts, settlors of conventional testamentary and irrevocable inter vivos trusts are motivated to establish trusts by a desire for special services and care for their beneficiaries, not merely investment guidance.¹⁶⁵ Of course, settlors of testamentary and irrevocable

bank undertakes to purchase stock for the account of its individual customers or to commingle assets which it has *received for a true fiduciary purpose* rather than for investment. These activities, unlike the operation of an investment fund, do not give rise to a promotional or salesman's stake in a particular investment; they do not involve an enterprise in direct competition with aggressively promoted funds offered by other investment companies; they do not entail a threat to public confidence in the bank itself; and they do not impair the bank's ability to give disinterested service as a fiduciary or managing agent. *In short, there is a plain difference between the sale of fiduciary services and the sale of investments.*

Id. (emphasis added) (citing 26 Fed. Res. Bull. 393 (1940), which is quoted *supra* in note 162); see also Investment Advisers Act § 202(a)(13), 15 U.S.C. § 80b-2(a)(13) (1994) (defining investment supervisory services).

¹⁶⁴ Since *Camp*, however, the presence of a trust seems to have become the de facto test of Glass-Steagall compliance. Thus, commercial banks may offer common trusts for individual retirement accounts. See *Investment Co. Inst. v. Conover*, 790 F.2d 925, 930 (D.C. Cir. 1986) ("The existence of a trust relationship is sufficient, by itself, to take this case out of *Camp*'s express teaching."); *Investment Co. Inst. v. Clarke*, 789 F.2d 175 (2d Cir. 1986); *Investment Co. Inst. v. Clarke*, 793 F.2d 220 (9th Cir. 1986); see also 2 LOSS & SELIGMAN, *supra* note 13, at 1028-29; Langevoort, *supra* note 23, at 707-09; Stokely G. Caldwell, Jr., Note, *Glass-Steagall and Collective Investment Trusts for Individual Retirement Accounts: Fiduciary Purpose or Investment?*, 42 WASH. & LEE L. REV. 961 (1985). As noted below, these common trusts have been treated as securities for purposes of the Securities Act and the Investment Company Act, in large part because they are not considered primarily fiduciary. See *infra* note 169.

¹⁶⁵ The point is not that the settlors of conventional trusts are indifferent to investment management, but that they seek more. Cf. *Conover*, 790 F.2d at 937 (Glass-Steagall Act) ("[W]e do not believe that Citibank's characterization of the Trust as an 'investment opportunity' should bear on whether the Trust constitutes a bona fide fiduciary service. The two terms are not mutually exclusive. Any fiduciary service is also an investment opportunity if by that one means an opportunity to earn a return on one's money; very few customers would likely be satisfied with the services of a bank's trust department if the bank did no more than safekeep their funds. We agree with the Comptroller that the proper inquiry is whether

inter vivos trusts presumably want to realize a good return and protect the corpus. However, other objectives are also important to them, including shepherding resources, fairly apportioning benefits among beneficiaries and balancing the interests of immediate beneficiaries against those of remaindermen. If the test for classification of a trust account as a security is the primacy of investment intent, indicia of such intent might include irrevocability¹⁶⁶ and an underlying transfer of the use of assets from the settlor to another beneficiary.¹⁶⁷

Camp involved the definition of security under the Glass-Steagall Act, and perhaps it does not govern definitional questions under the securities statutes. Although the Court did say that the definition of security under the Glass-Steagall Act was not to be construed narrowly, it stopped short of equating it to the definitions in the securities statutes.¹⁶⁸ *Camp* thus left open the possibility that trust participations that are not securities under the Glass-Steagall Act might

the bank is offering a genuine fiduciary service in addition to an opportunity to earn a return.”). Ironically perhaps, portfolio managers for conventional trusts typically handle many more accounts than do pension fund and investment advisory account managers, while they are usually less experienced and competent as investment managers than the latter. See EDWARD S. HERMAN, CONFLICTS OF INTEREST: COMMERCIAL BANK TRUST DEPARTMENTS 59 (1975).

¹⁶⁶ But see *International Asset Management, Inc.*, 1990 SEC No-Act. LEXIS 294 (Jan. 29, 1990) (declining to give no-action assurance for irrevocable term trust arrangement); *infra* note 179 and accompanying (discussing *International Asset Management*). As discussed below, the Philanthropy Protection Act of 1995, Pub. L. No. 104-62, 109 Stat. 682 (1995), has exempted certain charitable collective investment funds from the definition of investment company under the Investment Company Act. See *infra* text accompanying notes 188-97. The statute provides only conditional relief for funds that include revocably donated assets, Pub. L. No. 104-62 § 2(a) (to be codified at 15 U.S.C. § 80a-3(c)(10)(B)(vi), (vii)), on the theory that “donors of revocable gifts may not have a ‘true charitable intent’ as opposed to the ‘intention of an investor.’” H.R. REP. NO. 104-333, *supra* note 35, at 11-12 (1995), reprinted in 1995 U.S.C.C.A.N. 627.

¹⁶⁷ See *Langevoort*, *supra* note 24, at 708 n.122; see also 2 LOSS & SELIGMAN, *supra* note 13, at 1062-63 n.452 (“It has accordingly been suggested that a better line to achieve the legislative purpose is Professor Scott’s, to the effect that one useful classification of the principal purposes of trusts is ‘a general division into trusts created for the purpose of distributing the bounty of the settlor and trusts created for business purposes.’”) (quoting 2 AUSTIN WAKEMAN SCOTT, THE LAW OF TRUSTS 514 (2d ed. 1956), quoted in turn in Robert H. Mundheim & Gordon D. Henderson, *Applicability of the Federal Securities Laws to Pension and Profit-Sharing Plans*, 29 LAW & CONTEMP. PROBS. 795, 803 (1964)). But see *supra* note 164 (explaining that common trusts for individual retirement accounts are not securities for purposes of the Glass-Steagall Act).

¹⁶⁸ See *Camp*, 401 U.S. at 635.

be securities under the Securities Act.¹⁶⁹ On the other hand, the factor of investment intent that *Camp* made the essential feature of a "Glass-Steagall Act security" supports the conclusion that participations in testamentary trusts and run-of-the-mill irrevocable inter vivos trusts are not securities under either statute. Courts and the SEC's Division of Investment Management have insisted that under the securities statutes, trusts are securities when the settlor's primary motivation is not to secure fiduciary services.¹⁷⁰ On the other hand, when the settlor's primary purpose is to get fiduciary care, it hardly seems that settlors or beneficiaries require the separate protection of the securities statutes, especially since disclosure under those statutes would be inadequate for their protection in any event.

Howey held that an investment contract under the securities statutes is an arrangement in which the investor is "led to expect profits,"¹⁷¹ and this might

¹⁶⁹ In *Securities Indus. Ass'n v. Board of Governors*, the Court looked to the definition of the term security in the Securities Act to illuminate the meaning of the term in the Glass-Steagall Act. 468 U.S. 137, 150-52 (1984). *But see id.* at 160, 174-75 (O'Connor, J., dissenting) (distinguishing the statutes). However, the D.C. Circuit has since held that the word means different things in the two statutes. *See Conover*, 790 F.2d at 933-34; *see also id.* at 929 ("According to the Comptroller, moreover, 'the meaning of the term securities under the securities law [is] not necessarily synonymous with its meaning under the Glass-Steagall Act.'") (quoting Comptroller's ruling). In any event, the SEC has insisted that beneficial interests in common trust funds for individual retirement accounts are securities, and banks that have offered such interests have registered them under the Securities Act and registered the funds under the Investment Company Act while at the same time insisting that they are not offering securities for purposes of the Glass-Steagall Act. *See, e.g., id.* at 928 n.4; *Commercial Bank*, 1988 SEC No-Act. LEXIS 257 (Feb. 24, 1988); *United Missouri Bank*, 1981 SEC No-Act. LEXIS 4473 (Dec. 31, 1981); *see also* Elizabeth K. Norsworthy, *Common Trust Funds—A Three-Dimensional Puzzle with Pieces that Never Fit*, 3 INV. LAW. at 23-24 (May 1996).

¹⁷⁰ *See* cases cited *supra* note 151; *Commercial Bank*, 1988 SEC No-Act. LEXIS 257, at *1-2 (Feb. 24, 1988) ("[T]he [Investment Company Act] Section 3(c)(3) exclusion is available only if the common trust fund holds funds from individual trust accounts created by customers for bona fide fiduciary purposes. Bona fide fiduciary purposes involve, broadly speaking, those situations in which a bank is providing to individual trust accounts traditional estate planning and other fiduciary services, but not primarily money management."); *First Jersey Nat'l Bank* 1987 SEC No-Act. LEXIS 2797 (Nov. 13, 1987); *United Missouri Bank*, 1981 SEC No-Act. LEXIS 4473, at *2 (Dec. 31, 1981) ("The exception provided by section 3(c)(3) [of the Investment Company Act], the so-called 'common trust fund' exception, applies only to a common trust fund for moneys which a bank has received for bona fide fiduciary purposes."); *Wells Fargo Bank*, 1977 SEC No-Act. LEXIS 1823 (July 15, 1977); Norsworthy, *supra* note 169.

¹⁷¹ *Howey*, 328 U.S. at 298-99. Another useful indicator of a settlor's interest is the nature of the marketing program which attracted her to the trustee in the first place. *See infra*

be read to exclude trusts of the classical variety, in which the primary motive of the settlor is something other than an expectation of profits. The Supreme Court developed the concept of "expectation of profits" in *United Housing Foundation, Inc. v. Forman*,¹⁷² in which it held that shares of stock of Co-op City (a subsidized residential cooperative) that entitled the owners to live in an apartment in the cooperative were not securities.¹⁷³ The owners argued that the shares were investment contracts because their rent was to be reduced by virtue "of net income derived from the leasing by Co-op City of commercial facilities, professional offices and parking spaces, and its operation of community washing machines."¹⁷⁴ The Court was not convinced, however, in part because the desired profits were "speculative," "insubstantial" and only "incidental" to the purpose of their investment,¹⁷⁵ and, more to the point as the Court saw it, because the plaintiffs had been motivated to buy their shares "solely by the prospect of acquiring a place to live, and not by financial returns on their investments."¹⁷⁶

On an investment-consumption continuum, conventional inter vivos and testamentary trusts fall somewhere between investment transactions that are clearly securities, and consumption transactions that are not. Trust settlors typically want a good return, and the expectation of profits cannot be said to be insubstantial.¹⁷⁷ On the other hand, when settlors set up conventional trusts, their primary goal is to gain trusteeship, and investment return is in an important sense only an "incidental" goal. *Forman* suggests that an investor's motive matters, and it supports the proposition that the test for classifying a trust under the securities statutes is the relative importance of the settlor's investment intent.¹⁷⁸

Part II.C.

¹⁷² 421 U.S. 837 (1975).

¹⁷³ See *id.* at 847.

¹⁷⁴ *Id.* at 855-56.

¹⁷⁵ *Id.* at 856-57.

¹⁷⁶ *Id.* at 853; see also *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 561-62 (1979).

¹⁷⁷ See *supra* note 165.

¹⁷⁸ Cf. *SEC v. Heritage Trust Co.*, 402 F. Supp. 744, 749 (D. Ariz. 1975) ("The Court has reviewed the recent Supreme Court decision in *United Housing Foundation, Inc. v. Forman* Although defendants' sales brochures placed some emphasis on avoidance of probate as one of the advantages of a trust, it is also clear that the prime inducement was investment expertise, safety, and assured substantial return. It is difficult to believe any trustor would have invested without anticipation of a safe investment and a profitable return. *United Housing* does not dictate a result different from that reached here."); 2 LOSS & SELIGMAN, *supra* note 13, at 939 (*Forman's* "notion involves a weighing of the purposes of an investment. When the profit-producing purpose is incidental, the purchase will not be

Recent developments further obscure the question of whether a trust designed and used to accomplish ends beyond investment management may be a security. In 1990, the SEC's Division of Investment Management refused to assure International Asset Management, Inc. ("IAM"), an investment manager, that it would not recommend enforcement action if IAM marketed trust arrangements designed to protect the assets of wealthy investors against court judgments.¹⁷⁹ IAM proposed that wealthy investors would place substantial assets in trusts organized in foreign jurisdictions that might not enforce judgments of United States courts.¹⁸⁰ An affiliate of IAM would offer investment management services to the trusts, although a settlor could elect to direct the trust's investments. Settlor would be entitled to replace the trustees of their trusts (including another IAM affiliate), except at times when they were subject to litigation in the United States.¹⁸¹ This right, IAM suggested, would lead it to provide each settlor individualized service and to follow his or her directions, for fear that otherwise the settlor would terminate IAM's lucrative connection to the trust.¹⁸²

IAM argued that, because the settlor of each trust would effectively control its investments and would receive individualized attention, the trusts would not be securities, and hence that the trusts as a group would not be an investment company.¹⁸³ However, the Division of Investment Management was concerned because a settlor would lose the power to replace the trustees in the event the settlor was subject to legal action in the United States.¹⁸⁴ Moreover, the Division was not persuaded that IAM's practical incentive to please the settlors would ensure that each settlor would "receive sufficiently individualized treatment (especially the ability to retain the indicia of ownership over the securities in its Account)."¹⁸⁵ Absent assurances of individualized treatment, the Division was unwilling to agree that the proposed trust arrangements were not securities.¹⁸⁶

International Asset Management was not a litigated case, and it may simply reflect the reluctance of the Division of Investment Management to give its imprimatur to a complicated and not altogether attractive arrangement.

denominated a security.").

¹⁷⁹ See International Asset Management, Inc., 1990 SEC No-Act. LEXIS 294, at *4-5 (Jan. 29, 1990); see also International Asset Management, Inc., 1989 SEC No-Act. LEXIS 1026 (Oct. 11, 1989).

¹⁸⁰ See International Asset Management, Inc., 1990 SEC No-Act. LEXIS 294, at *4-5.

¹⁸¹ See *id.* at *35.

¹⁸² See *id.* at *29.

¹⁸³ See *infra* Part III (discussing investment companies).

¹⁸⁴ See International Asset Management, Inc. 1990 SEC No-Act. LEXIS 294, at *3.

¹⁸⁵ *Id.* at *4.

¹⁸⁶ See *id.* at *39.

Moreover, IAM's plan contemplated that assets would typically return to the settlor at the end of the trust term, and perhaps the Division viewed the plan as the sale of an exotic financial instrument, not as a method for transferring wealth with strings attached.¹⁸⁷ However, it is noteworthy that the Division focused on the lack of individualized attention, and seemed unmoved by the fact that settlors creating such trusts would likely have been moved more by the desire to protect substantial personal assets from litigation than by a desire for investment guidance.

In 1995, Congress touched upon the possibility that trust interests may be securities in the Philanthropy Protection Act,¹⁸⁸ which accords special treatment under the Securities Act, the Exchange Act, and the Investment Company Act to charities that operate charitable pooled income funds, which are often organized as trusts.¹⁸⁹ Charitable donors transfer assets to these funds while retaining some property interest, typically a right to an income stream for life. The funds in turn commingle the donated assets, pay income to donors, and eventually pass along what is left to the charity.

Interests in such trusts would seem to be securities under *Howey*: the donor contributes money to a common enterprise (the fund) with the expectation of receiving profits (the retained income stream) arising from the efforts of others (the managers of the fund). The staff of the SEC has given such funds assurance that it will not recommend action under the Securities Act or the Investment Company Act if they meet certain conditions.¹⁹⁰ No-action letters may not bind private parties, however, and after a party brought an action alleging that the fund should have registered under the Investment Company Act,¹⁹¹ Congress promptly acted to codify the SEC's no-action position. It amended the Investment Company Act to exclude charitable pooled income funds, collective trust funds, and similar funds from the definition of investment

¹⁸⁷ See *supra* text accompanying note 167.

¹⁸⁸ 15 U.S.C. § 80a-3a (1995).

¹⁸⁹ See H.R. REP. NO. 104-333, *supra* note 166, at 5, 10, *reprinted in* 1995 U.S.C.C.A.N. 620, 626.

¹⁹⁰ In an interpretative release, the SEC stated that a fund must satisfy three conditions: (1) The fund must qualify to receive tax deductible contributions under section 642(c)(5) of the Internal Revenue Code; (2) written disclosures must be given to each prospective donor; and (3) contributions to the fund must be solicited by a volunteer or employee whose compensation is not based on the amount of gifts. See Securities Act Release No. 33-6175, 5 Fed. Sec. L. Rep. (CCH) ¶ 47,374 (Jan. 10, 1980) *codified at* 17 C.F.R. § 71.11016 (1996); see also H.R. REP. NO. 104-333, *supra* note 166, at 7, *reprinted in* 1995 U.S.C.C.A.N. at 622.

¹⁹¹ See H.R. REP. NO. 104-333, *supra* note 35, at 8, *reprinted in* 1995 U.S.C.C.A.N. at 623-24.

company,¹⁹² and amended the Securities Act and the Exchange Act to make interests in such funds exempted securities under those statutes.¹⁹³

The Philanthropy Protection Act took an interesting approach to charitable collective trust funds.¹⁹⁴ They are now excluded from the definition of investment companies, but they are only exempt from registration under the Securities Act and the Exchange Act; they may still be securities under those statutes, and indeed the legislative history suggests that they are, emphasizing as it does that the antifraud provisions of those statutes will still be available to the defrauded party.¹⁹⁵ The House Commerce Committee's report on the Philanthropy Protection Act—the only committee report—explains that the Act codifies the SEC staff's position, which it explains as follows:

The rationale for the staff's position with respect to charitable income funds is that the primary purpose of persons who transfer property to these funds is to make a charitable donation, not to make an investment. The staff has concluded that this donative intent—combined with, among other things, the protections afforded by disclosure to donors and the applicability of the anti-fraud provisions of the securities laws to the operations of charitable income funds—makes registration under the Federal securities laws unnecessary.¹⁹⁶

This approach gives uncertain guidance for those creating traditional trusts, whose "primary purpose," like that of donors to charitable collective trusts, is to do something other than make an investment.¹⁹⁷ In the Philanthropy Protection Act, Congress apparently decided that when a buyer's primary purpose for investing money is not to maximize income, registration under the Securities Act ought not to be required. Nonetheless, it left such investments as securities (if not as securities issued by investment companies), subject to the statutory antifraud provisions. Of course, Congress did not address the settlors of traditional trusts, and perhaps the most that can be said of them in light of this legislation is that the reason a settlor parts with money is apparently important, but not necessarily dispositive.

¹⁹² 15 U.S.C. § 80a-3(c)(10)(1994).

¹⁹³ 15 U.S.C. § 77c(a)(4)(1994) (Securities Act amendment); 15 U.S.C. §§ 78c, 78l (1994) (Exchange Act amendment).

¹⁹⁴ The Philanthropy Protection Act also amends the Investment Company Act to require funds to give information statements to donors, but this requirement is not a condition of the exemption. 15 U.S.C. § 80a-7(e) (1995); *see also* H.R. REP. NO. 104-333, *supra* note 35, at 13, *reprinted in* 1995 U.S.C.C.A.N. at 628-29.

¹⁹⁵ *See* H.R. REP. NO. 104-333, *supra* note 35, at 8, 10, 13, *reprinted in* 1995 U.S.C.C.A.N. at 624, 626, 629.

¹⁹⁶ *Id.* at 7, *reprinted in* 1995 U.S.C.C.A.N. at 623.

¹⁹⁷ *See supra* note 166 (noting special treatment of funds holding revocable gifts).

III. INVESTMENT MANAGEMENT ARRANGEMENTS AS INVESTMENT COMPANIES

The Securities Act and the Exchange Act are not the only federal securities statutes implicated when investment management arrangements are securities. Individual arrangements that are securities may also collectively constitute an investment company subject to the Investment Company Act of 1940. An investment company is "any issuer which . . . is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing . . . in securities."¹⁹⁸ The critical word issuer is defined to include any "person who issues or proposes to issue any security,"¹⁹⁹ a person in turn includes "a company,"²⁰⁰ which includes "any organized group of persons whether incorporated or not."²⁰¹ Within this structure, a set of managed accounts may be regarded as an organized group and therefore a statutory company.²⁰² If the managed accounts are securities, then the group of managed

¹⁹⁸ Investment Company Act § 3(a)(1), 15 U.S.C. § 80a-3(a)(1) (1994).

¹⁹⁹ Investment Company Act § 2(a)(22), 15 U.S.C. § 80a-2(a)(22) (1994) ("issuer" means every person who issues or proposes to issue any security, or has outstanding any security which it has issued.").

²⁰⁰ Investment Company Act § 2(a)(28), 15 U.S.C. § 80a-2(a)(28) (1994).

²⁰¹ Investment Company Act § 2(a)(8), 15 U.S.C. § 80a-2(a)(8) (1994) ("Company" means a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not; or any receiver, trustee in bankruptcy or similar official or any liquidating agent for any of the foregoing, in his capacity as such.").

²⁰² See generally Investment Company Act Release No. 21,260, *supra* note 62. The House Commerce Committee's report on the recently enacted Philanthropy Protection Act of 1995 recognizes that, given the structure of the Investment Company Act, a set of investment accounts may be an investment company. H.R. REP. NO. 104-333, *supra* note 35, at 6, reprinted in 1995 U.S.C.C.A.N. at 621-22.

The treatment of unincorporated entities as investment companies has been one of the more complicated developments of the federal securities laws, but it is now well settled that such entities may be investment companies. See *Prudential Ins. Co. v. SEC*, 326 F.2d 383, 388 (3d Cir. 1964) (holding that a segregated variable annuity account was an investment company); see also *SEC v. American Bd. of Trade, Inc.*, 751 F.2d 529, 536 (2d Cir. 1984) ("The SEC points out that the authority of the *Prudential* case has not been questioned by any court in the twenty years since it was decided. We have no disposition to assume such a role, and we perceive no valid distinction between *Prudential* and the case before us."); Investment Company Act Release No. 21,260, *supra* note 62, at 86,967 n.14; cf. *SEC v. United Benefit Life Ins.*, 387 U.S. 202 (1967) (reserving question of whether collective investment fund should be separated from insurance company and considered an investment company). See generally 2 LOSS & SELIGMAN, *supra* note 13, at 1009 ("If all this startles at first blush, it must be remembered that a corporation, too, is a *persona ficta*; one gets used to the idea.").

accounts is an issuer (*i.e.*, a company issuing securities (the accounts)). Finally, inasmuch as the purpose of the managed accounts is to invest in securities, the group of accounts is an issuer engaged in investing in securities, and hence an investment company.²⁰³

The legislative policy implicit in the Investment Company Act justifies treating related managed accounts as an investment company. Most of the dangers recited in section 1(b) of the Investment Company Act²⁰⁴ are present to a large degree when many individual accounts are under the control of a single investment manager. Like investment advisers to mutual funds, investment managers can exercise control over their clients' investment decisions, can serve their own purposes by placing overvalued securities in their clients' portfolios,²⁰⁵ can overtrade or engage in other questionable trading practices to generate commissions for their own purposes,²⁰⁶ and can subject their clients' accounts to unsafe leverage in hopes of improving investment performance.²⁰⁷ Without the Investment Company Act, owners of managed accounts, unlike investors in investment companies, would be without the protection provided

²⁰³ See Investment Company Act § 3(a)(1), 15 U.S.C. § 80a-3(a)(1) (1994). A set of managed accounts may be an investment company even if the portfolio of the managed accounts does not consist exclusively of securities. Section 3(a)(1) declares an issuer to be an investment company if it is engaged "primarily" in the business of securities investment. Section 3(a)(3) provides a numerical test: it includes any issuer that "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets" 15 U.S.C. § 80a-3(a)(3). Because, in many cases, there would be no intent to form a statutory investment company, a set of managed accounts, if subject to the Investment Company Act, might be considered an "inadvertent" investment company. See generally Edmund H. Kerr, *The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act*, 12 STAN. L. REV. 29 (1959); Cohen & Hacker, *supra* note 151.

²⁰⁴ 15 U.S.C. § 80a-1(b) (1994). See generally 3 FRANKEL, *supra* note 16, ch. 18 § A2 (discussing policies underlying Investment Company Act); *Advisory Committee Report, supra* note 62, 39-58 (discussing investor protection and small-account management services).

²⁰⁵ See BINES, *supra* note 97, ¶ 10.06[2]. Similarly, assets might be moved from one mutual fund to another in anticipation of stock market moves. In *SEC v. Fundpack, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,951 (D.D.C. 1979), a special master was appointed to supervise the election of a new board of directors for a mutual fund that the court found to have been the victim of inadequate disclosure, self-dealing, and breach of fiduciary duty in connection with such practices. See *id.* at 95,981-82. The SEC charged the practices had caused wide fluctuations in the fund's net assets, thereby causing the fund to incur extraordinary operating costs and investment losses that had not been disclosed to shareholders. See *id.* at 95,979.

²⁰⁶ See BINES, *supra* note 97, ¶ 10.06[1].

²⁰⁷ See *id.* ¶ 5.03[2].

registered investment companies by outside directors, or the specific statutory restrictions on transactions with affiliates and interested persons.²⁰⁸

The current law governing whether managed accounts are investment companies can be traced back to the late 1960s, when First National City Bank ("Citibank") and Merrill Lynch offered a discretionary management program that essentially placed an investor into one of two portfolios depending on whether her objective was income or growth.²⁰⁹ Although the program was promoted as one offering individualized advice, in a 1970 lawsuit, the SEC took the position that the similarity of portfolios rendered each separate account a security, and that Citibank was operating an unregistered investment company.²¹⁰ The case eventually settled, with the SEC indicating that the bank could offer similar services to small customers, so long as the bank did not have discretionary authority over investments and customers were given a choice over which brokerage firm would handle their accounts. Since then, the SEC's staff has continued to take the position that the Investment Company Act is implicated if substantially similar advice is rendered to each of a group of accounts.²¹¹ The staff also asserted, in a related development, that participations

²⁰⁸ See Investment Company Act §§ 10, 15, 17(a)-(e), 15 U.S.C. §§ 80a-10, -15, -17(a)-(e) (1994). Most legal constraints against self-dealing as exist are aspects of the general antifraud provisions rather than detailed rules of conduct. Cf. Investment Advisers Act § 206(3), 15 U.S.C. § 80b-6(3) (1994) (stating that disclosure and written approval are necessary if adviser purchases or sells as principal).

²⁰⁹ The program, the Special Investment Advisory Service, was structured so that the customers would give the bank a power of attorney along with a deposit of at least \$25,000, together with instructions to invest in a particular portfolio of securities. The makeup of the portfolio depended on whether the customer's objective was income or growth, but all accounts opened at the same time with the same objective would be invested in the same portfolio.

²¹⁰ See SEC v. First Nat'l City Bank, Litigation Release No. 4534, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,592 (Feb. 6, 1970).

²¹¹ See Investment Company Act Release No. 21,260, *supra* note 35, at 86,967; Clarke Lanzen Skalla Investment Firm, Inc., Investment Company Act Release No. 21,140, 1995 SEC LEXIS 1508 (June 16, 1995); International Asset Management, Inc., 1990 SEC No-Act. LEXIS 294, at *2 (Jan. 29, 1990); Finanswer America/Investments, Inc., SEC No-Action Letter, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,111, at 80,406 (Mar. 26, 1971).

Registration of such an arrangement under the Investment Company Act would be necessary where substantially the same, or substantially overlapping, advice is rendered to each account or to a discernible group or groups of accounts, and where such accounts engage in the same securities transactions. Also, the interests offered in such an arrangement (the accounts) may be securities required to be registered

in a security are themselves securities, and that those participations, taken collectively, constitute an investment company.²¹²

Shortly after settling *Citibank*, the SEC established an Advisory Committee on Investment Management Services for Individual Investors.²¹³ The Committee concluded that individual ownership of securities in an investment account is so unlike the status of shareholders of traditional investment companies as to justify treating them differently.²¹⁴ Accordingly, the Committee concluded that an investment advisory arrangement should not have to register under the Investment Company Act, so long as the investors owned all their investments directly and the managers did not pool the assets of several managed accounts.²¹⁵ The Committee did conclude, however, that advisory services may constitute securities subject to the registration requirements of the Securities Act:

[T]he Committee believes that, under certain circumstances, the promotion and operation of an investment advisory service may involve a public offering of securities in the form of discretionary accounts. An investment service which is operated on a discretionary basis and does not afford investors individual attention would appear to be offering an investment contract or security, and if substantially the same investment advice is given to all clients or to discernible groups of clients, and clients are generally solicited, there could be a public

Id.; see also *Benchmark Sec., Inc.*, SEC No-Action Letter, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,424, at 86,117 (Jan. 9, 1976).

²¹² See *Josephthal & Co.*, SEC No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,116, at 85,125 (Nov. 25, 1974) (stating that participations in certificates of deposit and other commercial instruments are securities; the offeror may be an investment company); *Arthur E. Fox*, SEC No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,082, at 85,036 (Nov. 12, 1974) (stating that participations in a large-denomination certificate of deposit are securities; the offeror of the participations is an investment company); see also *Morgan Stanley & Co.*, SEC No-Action Letter, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,337, at 77,066 (Dec. 4, 1985) (referring to the "long-standing position" of the SEC's Division of Investment Management, "that the offer and sale to the public of certificates representing undivided participations in a security involves the offer and sale of a security separate from the underlying security and that the issuer of the separate security is subject to the 1940 Act, absent an appropriate exception or exemption").

²¹³ When it announced establishment of the Committee, the SEC explained that an "advisory service which makes large-scale solicitations of relatively small accounts and provides substantially the same advice to clients can become functionally indistinguishable from an investment company." Investment Company Act Release No. 7423, 1972 SEC LEXIS 24, at *1 (Oct. 12, 1972).

²¹⁴ See *Advisory Committee Report*, *supra* note 62, at 22-24.

²¹⁵ See *id.*

offering of one or more investment contracts or securities which should be registered under the Securities Act.²¹⁶

In 1980, the SEC proposed a rule to address the question of whether a set of advisory accounts is an investment company.²¹⁷ It explained that since the law in this area was not fully developed, it did not believe it would be appropriate to adopt a rule defining specifically which investment management services must register as investment companies.²¹⁸ Instead, the SEC proposed Investment Company Act Rule 3a-4, which would have provided a safe harbor from registration under the Investment Company Act for investment managers who provided their clients with individualized treatment.²¹⁹ The proposed rule would have required a manager to furnish continuous advice based on the individual needs of each client.²²⁰ The safe harbor in the proposed rule would also have been conditioned on the client's maintaining all indicia of ownership of the securities held in the account and the right to instruct a manager to refrain from making particular investments.²²¹

The proposed rule generated some controversy and was never adopted.²²² Nonetheless, the SEC's Division of Investment Management has regularly granted no-action letters to managers who have represented that they would comply with the terms of the proposed rule.²²³ Over time, however, the

²¹⁶ *Id.* at 23.

²¹⁷ See Individualized Investment Management Services, SEC Investment Company Act Release No. 11,391 [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,662 (Oct. 10, 1980).

²¹⁸ See *id.* at 83,572.

²¹⁹ See *id.* at 83,573.

²²⁰ The proposed rule would have required a significant amount of contact between the investment manager and its client, including an initial interview, followed by subsequent interviews at least annually, quarterly reports to the client, availability for consultation, and maintenance of the indicia of ownership by the client. See *id.* at 83,575.

²²¹ See *id.* The proposed release also indicated that if a management arrangement was operated within the proposed rule's safe harbor, the Division of Corporation Finance would not recommend enforcement action under the registration provisions of the Securities Act with respect to the arrangement. See *id.* at n.15.

²²² The tenor of comments on the proposed rule is interesting. Most commentators opposed the rule as being overly burdensome on managers, but the Investment Company Institute, which represents registered investment companies, complained that the rule would have allowed de facto investment companies to escape regulation. See Investment Company Act Release No. 21,260, *supra* note 62, at 86,968.

²²³ See *id.* at 86,968-99; see also Morgan Keegan & Co., 1990 SEC No-Act. LEXIS 1168 (Oct. 2, 1990); Qualivest Capital Management, Inc., 1990 SEC No-Act. LEXIS 1035 (July 30, 1990); United Missouri Bank, SEC No-Action Letter, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,421 (May 11, 1990) (involving a bank acting solely as custodian);

practices of groups of managed accounts have evolved. In 1972, the SEC's Advisory Committee described the typical arrangement as one marketed to investors who preferred not to invest in mutual funds.²²⁴ The SEC continued to be concerned with managers who provided portfolio services,²²⁵ but also with sponsors who delegated management to others, including sponsors who invested managed funds in mutual funds.²²⁶

In 1995, the SEC proposed a new rule 3a-4.²²⁷ The new rule is modeled on the original proposal, but modified in light of the SEC's experience with no-action letters. It would exclude certain investment management programs from the definition of investment company.²²⁸ Like the first proposed rule, the central theme of the new proposal is an insistence on individualized treatment.²²⁹ The proposed safe harbor would be available to an investment management program provided that:

- (i) Each client's account be managed on the basis of the client's financial situation, investment objectives, and instructions; (ii) the sponsor of the program obtain information from each client that is necessary to manage the client's account individually; (iii) the sponsor and portfolio manager be reasonably available to consult with clients; (iv) each client has the ability to impose reasonable restrictions on the management of the account; (v) each client be provided with a quarterly statement containing a description of all activity in the client's account; (vi) each client retain the indicia of ownership of all securities and funds in the account; (vii) the sponsor establish and effect written procedures that are reasonably designed to ensure that each of the conditions of rule 3a-4 is met; (viii) if the sponsor designates another person to perform certain obligations under the rule, the sponsor obtain from that person a written agreement to perform those obligations; (ix) the sponsor maintain and

Manning & Napier Advisors, Inc., SEC No-Action Letter, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,428 (Apr. 24, 1990) (outlining investment advisory service offered to clients where each client would be the registered and beneficial owner of the securities and retained custody); Jeffries & Co., SEC No-Action Letter, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,309 (June 19, 1989) (outlining personal money management service offered by subsidiary of registered broker-dealer).

²²⁴ See *Advisory Committee Report*, *supra* note 62, at 6.

²²⁵ See Investment Company Act Release No. 21,260, *supra* note 62, at 86,966.

²²⁶ See *id.* at 86,966-67; see also Clarke Lanzen Skalla Investment Firm, Inc., 1995 SEC LEXIS 1508, at *13-15 (June 16, 1995); Balliett, Blackstock & Stearns, Inc., 1987 SEC No-Act. LEXIS 2359 (Aug. 19, 1987).

²²⁷ See, Investment Company Release No. 21,260, *supra* note 62, at 86,969.

²²⁸ See *id.*

²²⁹ See *id.* ("The revised proposed rule would include a number of conditions intended to ensure that clients in programs that rely on the rule receive individualized treatment."); see also *id.* at 86,970 (discussing provisions designed to ensure individualized treatment).

preserve the policies, procedures, agreements and other documents relating to the program in the manner set forth in the rule; and (x) the sponsor furnish to the Commission upon demand copies of specified documents.²³⁰

While the proposed rule would provide at least some investment managers a clearly charted safe harbor from the Investment Company Act, several of its particulars would limit its usefulness to investment managers. First, a condition of the safe harbor is that the sponsor complete and file a form with the SEC.²³¹ Filing of this form is a condition of the safe harbor—if the form is not filed, there is no exemption.²³² Thus, a sponsor who structures a program that happens to satisfy the requirements of the rule but fails to file a form—perhaps because it has not considered the possibility that it is an investment company—will not have the safe harbor.²³³

In addition, the proposed rule provides a safe harbor only from the Investment Company Act, not from the Securities Act or the Exchange Act. However, the reason that investment managers have to worry about the Investment Company Act is the possibility that the investment management arrangements they offer may be securities, and the test of whether they are is the same under the several federal securities statutes.²³⁴ Accordingly, any manager who needs proposed rule 3a-4 also needs protection from the other statutes. The reason the proposed safe harbor is conditioned on a manager's giving individualized attention is to assure that the management arrangement is not a security. When the SEC proposed the rule, it recognized that if investment management arrangements are securities they implicate all the federal securities laws, not just the Investment Company Act, and it clearly intended that managers who satisfy the conditions of the rule would not have to register under the Securities Act.²³⁵ Nevertheless, the proposed rule only says that

²³⁰ *Id.* at 86,966; *see also id.* at 86,978–79 (containing text of proposed rule).

²³¹ The form is quite short, and consists largely of identifying information about the sponsor and a notice that the sponsor intends to rely on the rule 3a-4 safe harbor. *See id.* at 86,979.

²³² *See id.*

²³³ In contrast, the Regulation D exemption from the registration requirement of the Securities Act requires the issuer to file a Form D with the SEC, but failure to file does not destroy the exemption. *See* Rule 503, 17 C.F.R. § 230.503 (1995). The form required by proposed rule 3a-4 does not contain information that would be useful to investors, and even the SEC justifies it only as a tool for monitoring compliance with the proposed safe harbor. *See* Investment Company Act Release No. 21,260, *supra* note 62, at 86,976. However, by requiring filing of the form as a condition of the safe harbor, the SEC would succeed in retaining a jurisdictional hook on those availing themselves of the rule.

²³⁴ *See supra* note 35; *see also infra* note 248 and accompanying text.

²³⁵ The preliminary note to the proposed rule expressly states that interests complying

complying arrangements are not collectively an investment company; it does not say they are not securities. Accordingly, the proposed rule does not extend complying managers a safe harbor from the other federal securities statutes.

In any event, proposed rule 3a-4 offers only a safe harbor, not a complete definition of the term "investment company." Even if the SEC eventually adopts the rule, the status of managed accounts under the Investment Company Act will remain unsettled and investment managers will remain at risk. Investment managers who inadvertently create investment companies do risk substantial legal sanctions. Although the law governing the status of managed accounts as investment companies has developed largely in the context of SEC no-action letters, the SEC does actively enforce the Investment Company Act.

The recently settled case of *In re Clarke Lanzen Skalla Investment Firm*,²³⁶ shows that managers sometimes still run afoul of the registration requirements of the Investment Company Act, and that rather technical factors may determine whether a program is an investment company or not. Clarke Lanzen established about 360 accounts in what it called its "managed asset allocation program."²³⁷ Customers chose among six different investment strategies, such as aggressive, balanced, and conservative, each with its own predetermined investment formula. After a customer chose a strategy, the customer's funds were invested in various mutual funds, with the funds of all customers choosing a particular strategy invested in the same funds. Customers gave Clarke Lanzen discretionary authority, meaning that although customers retained authority to change their investment strategies or liquidate, they had no contractual right to instruct Clarke Lanzen to refrain from investing in a particular fund.²³⁸ The investments of all the customers in a particular mutual fund were carried in a single omnibus account in the custodian's name. Clarke Lanzen charged a set-up fee and an annual fee based on assets under management.²³⁹

The SEC instituted public administrative proceedings against Clarke Lanzen under the Securities Act and the Investment Company Act.²⁴⁰ The SEC found that the managed asset allocation program was an investment company, and that Clarke Lanzen violated section 7(a) of the Investment Company Act by

with the rule need not be registered under the Securities Act. *See* Investment Company Act Release No. 21,260, *supra* note 62, at 86,978, 86,969 n.26. Even if this note is binding as part of the rule, managers would still be subject to the other provisions of the Securities Act and the Exchange Act, including the antifraud provisions. *See id.* at 86,968 n.18 (stating no-action position of Division of Corporate Finance).

²³⁶ Investment Company Act Release No. 21,140, 1995 SEC LEXIS 1508 (June 16, 1995).

²³⁷ *Id.* at *2.

²³⁸ *See id.* at *8-9.

²³⁹ *See id.* at *7.

²⁴⁰ *See id.* at *1.

operating the program and offering interests therein without registering the program under the Investment Company Act.²⁴¹ The SEC followed the reasoning of *Citibank* and its no-action progeny, reasoning that “[i]f clients of a managed discretionary account program . . . do not receive individualized advisory services and do not retain sufficient indicia of rights traditionally associated with individual ownership of the securities purchased for their accounts, the pool of nominally separate client accounts in the program may be an investment company.”²⁴² The SEC applied the *Howey* test to determine whether interests in the program were securities for the purposes of the Investment Company Act, and concluded that they were, because the common enterprise element was satisfied by virtue of the pooling of the investors’ funds and the fact that the advisory fees were based on the value of assets under management.²⁴³ This finding also dictated a finding that Clarke Lanzen had violated section 5 of the Securities Act by offering and selling interests in the program without registering them under that Act.²⁴⁴

If managed accounts are securities, few would argue that those accounts should not be treated collectively as an investment company. The strongest argument that the Investment Company Act does not apply to a group of investment accounts classifiable as securities is that the Act was intended to apply only to pooled management, and that most investment management arrangements do not involve pooling. The SEC’s Advisory Committee on Investment Management Services for Individual Investors suggested this distinction, taking the position, as noted above, that an individual who owns securities in an investment account is so unlike the shareholder of a traditional investment company as to justify treating them differently.²⁴⁵

That argument, although it has some appeal, is unlikely to prevail. The distinction between pooled and nonpooled accounts finds no support in the Investment Company Act unless the meaning of “organized group” in the definition of “company” in section 2(a)(8) of the Act turns on whether the securities belonging to investment accounts are separated from each other. Such an interpretation, however, is sharply inconsistent with the SEC’s insistence that a collection of managed accounts is an investment company if the investors do not receive individualized attention.²⁴⁶ If a group of managed accounts are

²⁴¹ The SEC also found that the program violated section 12(d) of the Investment Company Act by investing more than 10% of its assets in the securities of registered investment companies. *See id.* at *13–15.

²⁴² *Id.* at *10.

²⁴³ *Id.* at *12.

²⁴⁴ *Id.* at *9.

²⁴⁵ *See Advisory Committee Report, supra* note 62, at 22–24.

²⁴⁶ *See supra* Part II.A.4; *infra* note 260 and accompanying text. The SEC’s position is

sufficiently related to be statutory securities, they are almost certain to be found to be sufficiently related to be members of an organized group.

Furthermore, the pooling-nonpooling distinction makes little policy sense, since the opportunities for investment managers to perpetrate the abuses which led to the passage of the Investment Company Act are not less likely simply because accounts are not pooled.²⁴⁷ An investment manager willing to dump an overvalued underwriting into a client's account will have more difficulty doing so when portfolios are maintained separately than when they are maintained in common. Similarly, an investment manager anxious to stimulate referrals by broker-dealers might trade clients' portfolios more rapidly than they would otherwise, regardless of whether the securities in each account are maintained separately or in common.

In the end, the question of whether a set of managed accounts is an investment company depends largely on the question of whether individual accounts are securities.²⁴⁸ Particularly under a *Howey* analysis, the same commonality that establishes an investment management operation as a statutory security also establishes it as a statutory investment company. To be sure, the SEC possesses discretionary authority to waive compliance with all or part of the Investment Company Act,²⁴⁹ and it could exempt managed accounts that comply with some form of safe-harbor rule. However, the SEC uses its discretionary exemption power sparingly and restrictively,²⁵⁰ as the experience of variable life insurance indicates,²⁵¹ and, as discussed above, the SEC has

that investment management arrangements are securities if investors do not retain the indicia of ownership of the assets in their accounts. *See supra* note 80. Investor retention of such indicia is not enough to prevent an arrangement from being a security; the SEC insists on individualized treatment as well.

²⁴⁷ *See supra* text accompanying note 11 (discussing declaration of policy in the Investment Company Act).

²⁴⁸ Conversely, if the individual interests are not statutory securities, no collection of such interests is an investment company. *See* Foundation Community Health Plan, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,150 (Jan. 23, 1975).

²⁴⁹ 15 U.S.C. § 80a-6(c) (1994).

²⁵⁰ *See* Robert A. Robertson, *The SEC Exemptive Process*, 3 INV. LAW. 11 (May 1996).

²⁵¹ The SEC had for some time maintained that variable life insurance ("VLI"), under which benefits are determined according to the asset value of a portfolio of securities, was itself a security and, therefore, that a set of VLI contracts constituted an investment company. After much controversy, the SEC adopted Investment Company Act Rule 3c-4, and Investment Advisers Act Rule 202-1, which exempted VLI from both of these statutes. Yet the ensuing opposition by interest groups opposed to these blanket exemptions (particularly the investment company industry) led to the qualification that state protective regulation comparable to that under the two federal statutes must exist before a federal exemption would

been slow to provide safe-harbor relief, and even the safe harbor it has proposed is incomplete.²⁵² The complications and problems that the Investment Company Act poses for investment management arrangements arise because those arrangements are treated as securities. To avoid those complications and problems, the extension of security status to investment management arrangements needs to be limited in the first place.²⁵³

IV. DEFINING SECURITY STATUS ON THE BASIS OF INDIVIDUALIZED TREATMENT

If all courts extended the *Howey* definition of investment contract to encompass managed accounts as easily as some have, the consequences for investment managers would be enormous. Investment managers provide a wide variety of services to large numbers of investors, often without ever considering the possibility that these activities are themselves securities. Aside from the mischief attendant to the SEC's selective exercise of its enforcement power, managers who fail to register under the Securities Act may face a particular risk, since under that Act buyers of unregistered securities can recover their investments from their sellers.²⁵⁴ If investment management arrangements are securities, investors have a put against their investment managers for the amount of their initial investments, regardless of how skillfully their investments have been managed.

As outlined above, the law governing the characterization of investment

attach. See Investment Company Act Release No. 8000, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,518 (Sept. 20, 1973). Since most states do not have such comparable regulation, and since most state insurance commissioners were not willing to have the SEC involved in the regulation of insurance sold within their jurisdictions, VLI could not actually be marketed. See generally Robert P. Blank et al., *Variable Life Insurance and the Federal Securities Laws*, 60 VA. L. REV. 71 (1974). The SEC then rescinded Rules 3c-4 and 202-1 and proposed instead to adopt a narrower exemptive rule under section 6(e). 15 U.S.C. § 80a-6(e) (1994). See BINES, *supra* note 97, ¶ 2.04[1].

²⁵² See *supra* notes 229-35 and accompanying text (discussing the proposed rule 3a-4 safe harbor).

²⁵³ Because the definitions of security are the same in the Securities Act and the Investment Company Act, see *supra* note 35, it would be difficult to limit the reach of the Investment Company Act by treating managed accounts as securities under the Securities Act but not under the Investment Company Act. See also *supra* note 235 and accompanying text (discussing failure to include express safe harbor from Securities Act in proposed rule 3a-4).

²⁵⁴ 15 U.S.C.A. § 77l(a)(1) (1996 Supp.). Courts have found that a parallel right of rescission is implied for purchases of shares of investment companies that have wrongfully failed to register under the Investment Company Act. See HAZEN, *supra* note 13, § 17.10, at 1014-15.

management arrangements as securities is cloudy at best. When the law began to cloud, however, several important constituencies began to suggest that the treatment of investment management arrangements under the securities laws ought to turn on the extent to which managers provide individualized services. This insight was not widely embraced at the time, but many of the cases and administrative decisions addressing the status of particular investment management arrangements under the securities laws tacitly respect a distinction based on individualized treatment of investors. In any event, there are good reasons for basing the characterization of investment management arrangements as securities in the absence of individualized treatment of managed assets.

In 1970, the SEC's Advisory Committee on Investment Management Services for Individual Investors suggested distinguishing investment management relationships on the basis of individualized treatment.²⁵⁵ The Advisory Committee concluded that investment management services tailored to the individual needs of an investor should not be regarded as a security, or at least should be regarded as exempted private offerings.²⁵⁶ While a private-offering theory still leaves managers liable to securities fraud,²⁵⁷ the concept of individualization as a basis for avoiding security status has appeal.

Although the SEC never adopted the Advisory Committee's recommendation in a formal rule,²⁵⁸ it has used individualized treatment as its

²⁵⁵ See *Advisory Committee Report*, *supra* note 62.

²⁵⁶ See *id.* at 24-25. The Advisory Committee took the position that in a case of true individualization, the need for disclosure is less immediate than where securities of industrial and investment companies are acquired, because close communication between client and adviser provides a perpetual feedback mechanism for indication of the client's approval or disapproval of investment decisions. The Committee also pointed out that the protective devices found in the Investment Advisers Act and, to some extent, in the Exchange Act of 1934, would still check unsavory practices. Further, the Committee suggested a new Advisers Act rule for these accounts, requiring the persons offering these services to give clients an information statement as would be specified in such a rule. In the view of the Committee, an information statement would be less costly, would afford greater flexibility as to content, and would be subject to a less formal review process than would a Securities Act registration statement, thus encouraging the growth of mini-accounts. See *id.* at 24-38.

²⁵⁷ The proposal to treat investment management arrangements as private placements would be difficult to accomplish, at least under existing law, given the restrictions implicit in the private offering exemption. See *supra* note 13 and accompanying text. Nor would a private-placement theory be of much use to commercial banks, because, although it suggests a means for avoiding registration under the Securities Act, it concedes that managed accounts are securities, so that the problem created by the underwriting prohibitions of the Glass-Steagall Act may still exist. See *supra* note 149 (comparing the definition of security in the Glass-Steagall Act with those in the securities statutes).

²⁵⁸ See SEC Securities Act Release No. 5491, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,767 (Apr. 30, 1974) (requesting public comment on the role of the SEC

basic test of determining whether a group of managed investment accounts is an investment company.²⁵⁹ Individualization is also the common thread uniting the requirements of the safe harbor from investment company status in proposed rule 3a-4.²⁶⁰ The test of individualized treatment is not simply a preference of the SEC and its Advisory Committee; it comports with the substantial body of law already addressed to the characterization of investment management arrangements, and furthers the policies underlying the federal securities laws.²⁶¹

By requiring investment managers either to treat their managed accounts as securities or to provide investors individual attention, a test of individualization ensures that before committing to a manager, investors will receive either extensive information immediately or the assurance of a close personal relationship and a stream of pertinent information that will permit them to evaluate their managers on a continuing basis.²⁶² Moreover, while

in dealing with bank-sponsored investment services).

²⁵⁹ See Investment Company Act Release No. 21,260, *supra* note 62. Compare International Asset Management, Inc., 1990 SEC No-Act. LEXIS 294 (Jan. 29, 1990) (declining to give no-action assurance to program with practical certainty of individual treatment) with Benson White & Co., 1995 SEC No-Act. LEXIS 553 (June 14, 1995) (giving no-action assurance to program in which sponsor represented it would offer individual treatment) and Wall Street Preferred Money Managers, Inc., 1992 SEC No-Act. LEXIS 648 (Apr. 10, 1992) (same) and West Am. Co. Inv. Co., 1991 SEC No-Act. LEXIS 1321 (Nov. 26, 1991) (same) and Morgan Keegan & Co., 1990 SEC No-Act. LEXIS 1168 (Oct. 2, 1990) (same) and S.H. Dike & Co., [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,246 (Mar. 21, 1975).

²⁶⁰ See Investment Company Act Release No. 21,260, *supra* note 62; see also *supra* notes 229-35 and accompanying text (discussing proposed rule).

²⁶¹ See *supra* Part II.A.4. The SEC's Advisory Committee also considered the applicability of the Investment Company Act to individualized accounts. Arguing that the policies underlying the Securities Act and the Investment Company Act are not identical, the Committee recommended that accounts not receiving individualized services be registered as investment companies, while those receiving individualized services not be registered. See *Advisory Committee Report*, *supra* note 62, at 22-23. Investment Advisers Act § 202(a)(13), 15 U.S.C. § 80b-2(a)(13) (1994), lends some support to the Committee's approach to avoiding registration under the Securities Act and the Investment Company Act. It defines "investment supervisory services" as "continuous advice" based on the "individual needs of each client." Under section 208(c), 15 U.S.C. § 80b-8(c), only those persons a substantial portion of whose activities consist of providing "investment supervisory services" may use the title "investment counsel." By granting this trade advantage, Congress itself made at least one important distinction in the area of investment management based on individualized services.

²⁶² See *supra* Part II.A.4. If prospective investors are to have sufficient information to reach a considered judgment before they commit their money, it is important that investors be

individualization may not be subject to precise definition, and thus might be difficult to define in particular cases, it is no less determinate than the other tests of security that courts have crafted, and at least the SEC has developed a substantial body of law distinguishing management programs on the basis of individualized treatment of investors.²⁶³ The SEC (or the courts) might also develop more clearly stated guidelines if individualization were acknowledged to be the critical question,²⁶⁴ and indeed proposed Investment Company Act Rule 3a-4 provides a relatively clear definition of individualized treatment and guidelines for meeting it.²⁶⁵

In assessing the test of individual treatment, it is fair to recognize that the manner in which an investment opportunity is promoted is often an important background consideration in deciding whether that opportunity is a security.²⁶⁶

assured of individualized treatment before investment management arrangements are created. To a substantial extent, this assurance can be provided by treating the way investment management arrangements are promoted as a factor in the test of individual treatment that determines whether they are securities. *See infra* text accompanying notes 261-71. In addition, a test of individualized treatment would require that, to avoid being treated as securities, investment management arrangements must be structured to guarantee that investors will receive individualized treatment after they have entered into those arrangements. *See supra* text accompanying note 127. Regulation of promotion and creation alone would be insufficient to assure individualized treatment, however, because a real test of individualized treatment requires that the manager's behavior be assessed as the relationship develops. This examination could be accomplished on an ad hoc basis or by the application of clear standards of management similar to those articulated in proposed rule 3a-4. *See supra* notes 229-35 (discussing proposed rule 3a-4).

²⁶³ *See* sources cited *supra* note 259.

²⁶⁴ The Advisory Committee recommended that the SEC publish guidelines on individualized treatment and offered a list of criteria for the SEC to consider in doing so. *See Advisory Committee Report, supra* note 62, at 27-32.

²⁶⁵ *See* Investment Company Release No. 21,260, *supra* note 62 (proposing rule); *see also supra* notes 229-35 and accompanying text (discussing proposed rule).

²⁶⁶ *Compare* *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995) (holding that section 12(2) of the Securities Act does not apply to privately negotiated secondary transactions) *and* *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (holding that a unique, privately negotiated profit-sharing agreement was not a security) *with* *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985) (holding that sale of all the stock of a corporation was a sale of securities).

In holding that commingled agency accounts are securities for purposes of the Glass-Steagall Act, the Supreme Court in *Investment Co. Institute v. Camp* emphasized that they are likely to produce promotional and performance pressures. 401 U.S. 617, 636-38 (1971). *Camp* thus suggests that, at least in some contexts, the way an investment is marketed is relevant to whether it is a security. Whatever might be said about the validity of the Supreme Court's distinction between commingled agency accounts and other bank-sponsored investment management arrangements, the Court did attempt to tie security status to concern

Indeed, one might accurately say that a concern with marketing and promotional practices pervades the cases dealing with the definition of

over the methods of promotion that banks might adopt.

Of course, banks do promote their investment management services—even those services that are not securities—to both institutional investors, like pension and profit-sharing accounts, and to individuals. Courts and commentators alike have spotlighted the tenuousness of the Supreme Court's attempted distinction between commingled agency accounts and other bank-sponsored and bank-managed investment services. See *Langevoort*, *supra* note 24, at 703-04.

The new structure of the banking industry makes a complete anachronism of *Camp*'s fiduciary rhetoric. One doubts that many sophisticated people today see the banker as anything but a businessperson under pressure to sell products and generate profits—not a likely source of “disinterested investment advice” unless that service is paid for.

Id.; see also *Investment Co. Inst. v. Conover*, 790 F.2d 925, 937 (D.C. Cir. 1986) (noting that banks likely face competitive pressures when they market collective trusts for IRAs, but holding they are still not securities); John W. Church, Jr. & Richard B. Seidel, *The Entrance of Banks into the Field of Mutual Funds*, 13 B.C. INDUS. & COM. L. REV. 1175 (1972); James G. Woltermann, Comment, *National Banks and Mutual Funds: Where Can They Go After Investment Company Institute v. Camp?*, 60 KY. L.J. 757 (1972). Perhaps *Camp* reflected less a response to the imperatives of the Glass-Steagall Act than to a decision that bank entry into the provision of investment management services had come so far as to require a general review by Congress. See *Langevoort*, *supra* note 24. Because, under a literal reading of the statute, the sale of participations in commingled agency accounts could easily be regarded as contrary to the statutory prohibitions against underwriting, and since the Court knew that Congress was examining the commingled agency account issue in connection with its hearings on amending the Investment Company Act, the Court's decision to hold the line against further bank encroachments is entirely understandable, if perhaps somewhat disingenuous. See, e.g., *Hearings on Mutual Fund Legislation of 1967 Before the Senate Comm. on Banking and Currency*, 90th Cong., Pt. 3, 1249 (1967); *Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 139, 179, 456-58 (1969). The report of the Senate Committee on Banking and Currency, 91st Cong., 10-12, 23 (1969), indicated that Senate Bill 5224 proposed expressly to authorize banks or savings and loan associations to operate a collective fund for managing agency accounts. The House Committee on Interstate and Foreign Commerce, in its Report, 91st Cong., 2d Sess. 9 (1970), refused to take a position whether commingled agency accounts were considered permissible under the Glass-Steagall Act. Recognizing that the *Camp* case was pending before the Supreme Court, however, the Committee did take the position that if such accounts were permitted, they ought to be regulated as investment companies. Both the House approach and the Senate approach were eliminated in conference. See *Conference Report, Investment Company Act Amendments of 1970, No. 163*, 91st Cong., 28-29 (1970).

“security.”²⁶⁷ Perhaps the security status of investment management arrangements depends not only on a lack of individual treatment, but also on how management services are marketed—how clients are sought, what promises are made, what information is disclosed and withheld, and so forth.²⁶⁸ However, the question of marketing may be more of a refinement of an individual-treatment test than a substitute for it.

Consider, for example, the Supreme Court’s approach in *Howey*. The Court emphasized both the investors’ passivity and the promoters’ creation and marketing of substantially similar, if not identical, interests in the orange-grove scheme. These factors indicate an absence of both individual treatment and public marketing. For investment management arrangements generally, on an individual-treatment analysis, red flags for security status might include heavy portfolio overlap²⁶⁹ or joint management of a large number of accounts.²⁷⁰ Yet, these elements will almost always be present when a manager markets investment management arrangements to many potential customers.²⁷¹ Once again, making marketing practices dispositive of whether an investment management arrangement is a security will, in the end, identify arrangements in which investors are unlikely to receive individual attention. However the test is phrased, individual treatment seems to be the key.

V. CONCLUSION

The general question of which investment management arrangements are securities for purposes of the federal securities laws is important to the extent

²⁶⁷ See HAZEN, *supra* note 13, § 1.5, at 31 (“[A] reading of all of the relevant [investment contract] cases leads to the conclusion that what is being offered may not be as important as how it is being presented.”); see also SEC v. Brigadoon Scotch Distributions, Ltd., 388 F. Supp. 1288, 1292 (S.D.N.Y. 1975) (referring to defendants’ “investment-oriented advertising”); *Advisory Committee Report*, *supra* note 62, at 17; Carney, *supra* note 38; FitzGibbon, *supra* note 38; cf. 17 C.F.R. § 230.151(a)(3) (1996) (establishing a safe harbor for annuities that are not marketed primarily as investments).

²⁶⁸ Cf. Carney, *supra* note 38, at 364 (suggesting that courts use a two-step analysis in defining securities).

²⁶⁹ See SEC Litigation Release No. 4534, 1970 SEC LEXIS 1195 (Feb. 6, 1970); Finanswer America/Investments, Inc., SEC No-Action Letter, [1970–1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,111 (Mar. 26, 1971).

²⁷⁰ See generally *Advisory Committee Report*, *supra* note 62.

²⁷¹ See *Advisory Committee Report*, *supra* note 62, at 19 (“Mass merchandising of discretionary accounts of relatively small size, through advertising in the mass media or similar promotional efforts, was viewed with skepticism by the [SEC’s] staff which believed that such activities would probably be inconsistent with individualized investment advice and services”).

that those laws affect the public interest, and the question of whether a specific arrangement is a security is certainly important to the investment manager and investors involved. Nonetheless, stating the law governing the general question with any precision is difficult, and whether a particular investment management arrangement will be treated as a security is often impossible to predict.

Although much of what appears to be discord in the case law is more rhetorical than real, courts do disagree about what constitutes a security. Moreover, authoritative determinations of security status have never been made with respect to vast numbers of investment management relationships. Nevertheless, certain factors do recur in authoritative determinations that particular investment management arrangements are securities.

An investment management arrangement is more likely to be found to be a security if the manager has made false statements of material facts relevant to the underlying investments or has failed to disclose a substantial risk that the investor will suffer if the manager's firm fails. Similarly, excessive optimism about the prospect for gain from using a particular investment approach, especially with insufficient reference to the risk of loss, can be an important factor in establishing security status.²⁷² Finally, a generalized advertising campaign, especially one going beyond mere solicitation of interest from investors seeking personal investment counseling, may support an inference that what is being offered is a security.

Undoubtedly, several forces push courts and regulators to hold investment management arrangements to be securities. Dissatisfied investors who can convince courts that managed accounts are securities can obtain relief under the antifraud provisions of the securities laws if the underlying investments are not securities—for example, when managers invest client funds in commodities or precious metals. Even when the underlying investments are in securities, if an investor can show that the managed account is itself a security, the Securities Act provides a neat remedy for recovering the account's lost value without showing that the manager was incompetent or engaged in fraud. If the arrangement was not registered and the manager cannot prove an exemption, then the investor can rescind under section 12(1).²⁷³ In contrast, the regulation of investment management services under other federal securities laws, particularly the Investment Advisers Act of 1940, is underdeveloped and offers investors relatively little protection. Recoveries are thus less certain than under the Securities Act, and litigation is likely to be more complex.

²⁷² Cf. *Dreyfus Gold Deposits, Inc.*, SEC No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,069, at 84,997 (Jan. 10, 1975) (withdrawing no-action assurance after Dreyfus suggested that the SEC had "cleared [its] plan based on its purported security, convenience, and inexpensiveness.").

²⁷³ 15 U.S.C.A. § 771(a)(1) (1996 Supp.).

From the point of view of the SEC, the Securities Act offers a useful vehicle to police investment managers who offer services of doubtful merit and managers who make technically accurate statements that are likely to take advantage of investor naïveté. By enjoining the marketing of an investment program for nonregistration,²⁷⁴ the SEC can pre-empt the use of programs it believes may be fraudulent without proving fraud. In doing so, the SEC does not so much perfect the disclosure philosophy of the securities laws to ensure that investors have information before engaging investment managers, as it completely prevents the marketing of services of which it disapproves.

The SEC's interests have predominated in the law governing whether investment management arrangements are investment companies, because much of the authoritative discussion of that question is contained in SEC responses to requests for no-action assurance. In that context, the SEC has an incentive to broadly construe the term security in order to maximize its jurisdiction, because only if investment management arrangements are securities can collections of such arrangements be subject to regulation as investment companies.²⁷⁵ In assessing what moves the SEC's general approach to the question of whether investment management arrangements are securities, one should note that the SEC has done little to assist investment managers who want to provide information to prospective investors without running afoul of the registration provisions. The SEC first proposed rule 3a-4 fifteen years ago and has never issued a Securities Act registration form specifically tailored for the offering and selling of investment management services and for responding to the needs of persons interested in such services.

A final explanation for the intrusion of the securities laws into arrangements between investment managers and their clients lies in the fragmentation of federal regulation of investment management.²⁷⁶ For some time, the investment management activities of underwriters, broker-dealers, commodity trading advisers, insurance companies, investment counselors, and banks have been regulated by different regulatory authorities acting under separate administrative regimes. Compartmentalized regulation of comparable activities has created discontinuities that generate regulatory strain, and perhaps the natural response has been for courts and the SEC to find a common basis for regulation under the securities laws.

While these considerations may explain why various actors want investment management arrangements to be treated as securities, they do not justify using

²⁷⁴ See 15 U.S.C. §§ 77t(b), 78u(d), 80a-41(d) (1994) (authorizing SEC to seek injunctions).

²⁷⁵ Cf. *supra* note 231 and accompanying text (discussing reporting requirement under proposed rule 3a-4).

²⁷⁶ See *supra* Part I.B.

an expansive definition of security to accomplish regulation of investment management. Other remedies are available to deal with fraud in the marketing of investment management services and fraud and mismanagement in their operation, without adding a guarantee against investment failure under the securities laws. Moreover, to the degree the SEC or private plaintiffs succeed in applying the securities laws selectively to offers of investment management services, they also burden investment management arrangements which are conducted honestly and properly.²⁷⁷

Nonetheless, the securities laws have a proper place in the regulation of investment management arrangements when managers provide common management service to various investors instead of tailoring management to the needs of each investor. An appropriate balance between permitting investment management practices to evolve and protecting the interests of investors can be achieved by treating investment management arrangements as securities unless managers act on the basis of each client's individual financial situation, investment objectives, and instructions. Individualized attention is expensive of course, and providing individualized attention to small investors on a profitable basis may be impossible. Certainly, many managers faced with the cost of complying with the securities laws would decline to offer nonindividualized management services to small investors. Mutual funds, on the other hand, do provide nonindividualized management services to small investors, and they do so under a regulatory regime designed to protect those investors. Perhaps those who desire nonindividualized investment management services ought to be directed to mutual funds, and those who wish to provide such services ought to comply with the regime that regulates mutual funds. In any event, that seems to be the decision enacted in the securities laws, and that decision is effectuated by treating nonindividualized investment management arrangements as securities.

²⁷⁷ In this regard, the quick enactment of the Philanthropy Protection Act is instructive. See *supra* notes 188-97 and accompanying text.